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IN THE

Supreme Court of the United States

October Term, 1969
No. 1036

BAKER COMMODITIES, INC.,

Petitioner,

vs.

THE UNITED STATES OF AMERICA,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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BAKER COMMODITIES, INC.,

Petitioner,

vs.

THE UNITED STATES OF AMERICA,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

To the Honorable, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioner, Baker Commodities, Inc., prays that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Ninth Circuit, affirming the decision of the Tax Court of the United States in this case.

Opinions Below.

The opinion of the Court of Appeals, reported at 415 F. 2d 519, appears in Appendix A. The Findings of Fact and Opinion of the Tax Court are reported at 48 T.C. 374 (1967) and appear in Appendix B.

Jurisdiction.

The judgment of the Court of Appeals was entered on August 8, 1969. A timely Petition for Rehearing, filed by this petitioner, was denied on October 7, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Questions Presented.

This petition presents important and complex issues of statutory construction with respect to several provisions of the Internal Revenue Code. On some of the issues, the decisions of the Ninth Circuit and Tax Court conflict with other federal decisions, including a recent decision of the United States Court of Claims rendered during the pendency of this appeal. Other questions are largely matters of first impression but they are by no means unique and will undoubtedly have a significant impact on the future administration of the relevant Code sections. Petitioner submits that upon analysis it will be seen that the Ninth Circuit's reasoning and determination of those questions is not only erroneous, but so superficial and inadequate that it should not be permitted to stand as the only appellate court decision on matters of such importance.

The questions presented are:

1. Whether the *Kimbell-Diamond* doctrine has been preempted by §334(b)(2) of the Internal Revenue Code of 1954, so that if the technical requirements of that section are not met, a purchase by one corporation of the stock of another followed immediately by liquidation to acquire its assets, must be treated for tax purposes as an ordinary liquidation of a subsidiary under §332, with a carryover basis under §334(b)(1), even

though in substance the transaction is the same as a direct purchase of assets entitling the purchaser to a new cost basis under §1012. The decisions below conflict with the Court of Claims on this question.[1]

2. Whether a single sale of all of the assets of a partnership, used in a business which had become dormant prior to the sale, is to be treated for tax purposes as a mere sale of assets with the partnership remaining in existence; whereas, a sale of all of the partnership assets in a "going business" would be treated as a sale of the total partnership interest, terminating its existence under §708(b) of the Internal Revenue Code. The decisions below conflict with other appellate decisions on the principles governing this question.

3. Whether a partnership which dissolves as the result of an installment sale of all its assets, causing a revocation of the agency relationship under partnership law, nevertheless remains a "partnership" within the meaning and purpose of the stock attribution rules of §318 of the Internal Revenue Code, so long as it continues collecting and distributing the proceeds from the sale, making its partners the constructive owners of each other's shares of stock acquired subsequently in an unrelated venture. This important matter of first impression was wrongly decided below.

4. Whether, consistent with Congressional intent, the exclusion in §334(b)(3)(C), from the statutory definition of the term "purchase" for purposes of applying §334(b)(2), includes transactions in which the

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[1]The *Kimbell-Diamond* doctrine derives its name from the landmark case of *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1960), aff'd per curiam, 187 F. 2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827, 72 S. Ct. 50, 96 L. Ed. 626.

critical 50% or more ownership of the acquiring corporation by the seller does not reside in any one individual and must be created by combining, under §318, the actual and constructive ownership interests of several individuals (which constructive ownership, in the instant case, is itself the result of so-called "sidewise attribution" from otherwise unrelated individuals through common partnerships). This important question of first impression was wrongly decided below.[2]

Statutes Involved.

The relevant provisions of the Internal Revenue Code of 1954, as amended (Title 26 U.S.C.), are set forth in Appendix C.

Statement.

A. The Tax Court's Findings of Fact.

On June 26, 1961, petitioner, a California corporation, purchased all of the outstanding stock of two corporations, Baker Commodities, Inc. (herein called "Old Baker") and Kerman Tallow Works, in order to acquire their assets. In said transaction, petitioner purchased 100% of the stock of Old Baker and 50% of the stock of Kerman Tallow from the Jerome Brothers Partnership, consisting of three brothers, Frank, Paul and Varney Jerome. The remaining 50% of the stock of Kerman Tallow was acquired by petitioner in a simultaneous purchase from an unrelated party, R. S. Wilson Co. Immediately after purchasing said stock, petitioner adopted a plan to completely liquidate both of the ac-

[2]The citations to §318 refer to that section as it existed during the taxable years involved herein which ended June 30, 1961, 1962, and 1963. Section 318 was amended by P. L. 88-554, §5(a), effective August 31, 1964, expressly prohibiting sidewise attribution. [See App. C and D.]

quired corporations, which plan was completed by June 30, 1961. The transaction was intended to permit petitioner to obtain a cost basis for the assets measured by the purchase price paid for the stock, in accordance with the provisions of §334(b)(2) of the Internal Revenue Code. [App. B, 29-30, 36-38.][3]

On December 20, 1962, petitioner purchased the stock of another corporation owned by the Jeromes, Veronica Compania Naviera, S.A., and immediately liquidated it to acquire its assets in a transaction intended to comply with §334(b)(2). [App. B, 47-51.][4]

The three Jeromes owned only 10% each of petitioner's stock. The remaining 70% was owned equally by seven individuals who had been key employees of the business formerly carried on by the Jerome Brothers Partnership. Petitioner's shares had been issued on June 23, 1961. [App. B, 28-29.]

Both the 1961 and 1962 transactions between the Jeromes and petitioner were entirely bona fide. The court expressly found that the Jeromes were in fact only minority stockholders and they did not control petitioner. [App. B, 40, 41, 59-63.] Moreover, the prices paid for the stock purchased by petitioner were arrived at by arms-length negotiations (the 1961 price was based largely on independent appraisals) and represented fair prices for the assets acquired. [App. B, 47-51, 64.]

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[3]The stock of two other corporations was also purchased by petitioner in the June 26, 1961 transaction, but petitioner did not liquidate them and continued to operate them as subsidiaries. The basis of those assets is not involved in this case.

[4]Technically, the Veronica stock was purchased by petitioner from the Jeromes as individuals, whereas the stock of Old Baker and Kerman was purchased from the Jerome Brothers Partnership.

Prior to the June 26, 1961 transaction, the Jeromes and five of the seven keymen who became stockholders of petitioner had been members of a partnership known as Manchester Medical Hospital. Each of the three Jeromes owned 11.11% of Manchester and each of the five keymen owned 4.17%; the balance was owned by seven other unrelated individuals. Manchester was at all times a completely independent entity whose sole purpose and business of operating a convalescent hospital was in no way connected with that of petitioner or the Jerome Brothers Partnership. When Manchester ran into financial difficulty, the hospital was closed in July, 1960, and remained inoperative until it was sold. On March 1, 1961, Manchester sold and conveyed the hospital and all of its assets to an unrelated corporate purchaser, receiving an installment note for the purchase price. Thereafter, Manchster no longer engaged in any business of any sort. [App. B, 43-45.]

In order to report the income received from the installment sale of its assets, a partnership tax return was prepared and filed for Manchester for 1961 and 1962. Its final return for the fiscal year ended August 31, 1962 reported collections on the note and showed a balance still due. No other receipts or gross income was reflected. [App. B, 45.]

B. The Tax Court's Conclusions.

The Tax Court held that the stock which petitioner purchased in both the June 26, 1961 and December 20, 1962 transactions was acquired from a person whose stock was attributed to petitioner under §318 and, accordingly, was not "purchased" for purposes of applying §334(b)(2), by reason of the exclusion contained in §334(b)(3)(C). [App. B, 74-75, 77-81.]

The Court's conclusion that the stock of the Jerome brothers was attributable to the petitioner, rests initially on §318(a)(2)(C), which attributed to petitioner any stock owned by "any person" who owned directly or indirectly 50% or more of petitioner. Individually, none of the Jeromes in fact owned either directly or indirectly the required 50%. However, the Tax Court combined the 10% owned actually by each of the three brothers, attributing such stock to the Jerome Brothers Partnership under §318(a)(2)(A). To this combined 30%, the court added 16.5% derived from the following multiple step application of the partnership attribution rules: the 10% of petitioner's stock owned by each of the five keymen (50% combined) who were partners in Manchester was attributed to Manchester; each of the three Jeromes was then deemed to own constructively 11.11% of the 50% constructively owned by Manchester, or 5.5% each, by reason of his partnership interest in Manchester; such 5.5% was then attributed again to the Jerome Brothers Partnership. Five percent of petitioner's stock was also attributed to the Jerome Brothers Partnership from a sixth keyman in a similar three-step application of the attribution rules through another common partnership, Keith Engineering Co. Altogether, this process added up to a total of 51.5% of petitioner's stock being deemed constructively owned by the Jerome Brothers Partnership. [App. A, 6-7.][5]

[5]Section 318 does not provide for attribution between brothers. The most any one of the brothers could be deemed to own actually and constructively (through multiple partnership attribution and reattribution) would be 28.61%. This would require a fourth step, reattributing to each brother one third of the shares attributed to the Jerome Brothers Partnership through each of the other two brothers, which in turn came from the keymen through Manchester and Keith Engineering.

The key link in this complex chain of attribution was supplied by the Tax Court's conclusion that Manchester remained an existing "partnership" within the meaning and contemplation of §318, after all of its assets had been sold on March 1, 1961, which existence had not terminated at the time of either the June 26, 1961 or December 20, 1962 transactions. It was held that Manchester continued to exist, "at least for the purpose of receiving the unpaid balance on the promissory note" (because tax returns were filed showing collections on the purchase price for the sale of Manchester's assets); and, hence, it was still "winding up its corporate (sic) affairs and therefore was in existence for the purpose of applying the attribution rules of section 318(a)." [App. B, 78-80.] The court relied on its own earlier decision in *J. Milton Sorem*, 40 T.C. 206 (1963), Rev'd on other grounds, 334 F. 2d 275 (10th Cir. 1964), for the proposition that "mere existence" of a partnership relationship, for any purpose, is sufficient to satisfy the purpose of the attribution statute. [App. B, 79-80.]

The Tax Court also rejected the contention that the statute should not be construed as permitting multiple and compound attribution to create what amounts to artificial control (though it questioned "the philosophy" of doing so in this case) on the ground that the literal wording of the statute had to be given effect. [App. B, 80-81.][6]

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[6]As an alternate ground applicable only to the June 26, 1961 transaction, the Tax Tax Court held that petitioner had acquired the stock of Old Baker and Kerman Tallow pursuant to a nontaxable exchange under §351 of the Internal Revenue Code. [App. B, 67-74.] Such conclusion was based on the theory that

(This footnote is continued on the next page)

C. The Decision of the Court of Appeals.

The court of appeals affirmed the decision of the Tax Court, holding (1) that §318, as it existed prior to the 1964 amendment, required "sidewise attribution," reattributing the same stock several times under various rules of constructive ownership [App. A, 10-11]; and (2) that Manchester retained its "existence" for §318 purposes after its cessation of business and the sale of all of it assets, because it was still collecting and distributing the proceeds on the purchaser's installment note. [App. A, 11-16.]

Under the opinion of the court of appeals, a formal, final termination of a partnership and complete distribution of all of its assets, including receivables, is required before it ceases to be a viable "partnership" for purposes of stock attribution between partners. The court expressly rejected petitioner's contention that the underlying basis for the partnership attribution rules of §318 is the existence of an agency relationship between

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the 15 year notes given to the sellers, though representing a bona fide indebtedness, must be regarded as "securities." Accordingly, the acquisition was deemed to fall within §334(b)(3)(B), another statutory exclusion from the definition of "purchase" for §334(b)(2) purposes. Although the Court of Appeals did not reach this issue, the Tax Court's construction of §351 was, under its own findings of fact, erroneous as a matter of law and contrary to numerous federal decisions, including: *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Miller's Estate v. Commissioner*, 239 F. 2d 729 (9th Cir. 1956); *Sun Properties, Inc. v. United States*, 220 F. 2d 171 (5th Cir. 1955); *Steven's Pass, Inc.*, 48 T.C. 532 (1967); *Charles E. Curry*, 43 T.C. 667 (1965); *Arthur F. Brooks*, 23 T.C.M. 1730 (1964), Rev'd on other grounds, 360 F. 2d 1011 (2nd Cir. 1966); *Harry F. Shannon*, 29 T.C. 702 (1958); *Warren H. Brown*, 27 T.C. 27 (1956), Acq., 1957-2 C.B. 4. This portion of the Tax Court's decision has already been cited in another decision, *George A. Nye*, 50 T.C. 203, 210 (1968), and undoubtedly will continue to be urged as authority for a seriously incorrect proposition of law, casting a pall of uncertainty over the entire area of long term installment sales to newly organized corporations.

partners and partnership. Accordingly, it rejected petitioner's argument that after a partnership has "dissolved" under state partnership law, and the agency relationship is thereby revoked as to all matters except those relating to the winding up of the pre-existing affairs preparatory to final termination, it should no longer be regarded as supporting an application of §318 to stock acquired by its partners in a subsequent, unrelated transaction. [App. A, 15.]

The court of appeals also held, *contra* petitioner's position, that the single sale of all of Manchester's assets, after which it no longer operated any business, did not constitute a sale of the *partnership interest* (as distinguished from a mere sale of assets); and hence, that there was no "termination" within the meaning of §708(b)(1)(B) (automatic and immediate termination by the sale of 50% or more of the partnership interest within a 12-month period). Nor did the court accept petitioner's alternative argument that mere collection and distribution of the proceeds from the final sale of the partnership assets and reporting them in a partnership tax return, should not be regarded as continuing to carry on the business of the partnership, preventing a termination by cessation of business under §708(b)(1)(A). [App. A, 13-14, 15.]

The Ninth Circuit concluded with the same quote from *J. Milton Sorem, supra,* cited by the Tax Court, to the effect that mere existence of the partnership relationship for any purpose is sufficient to invoke §318. [App. A, 16.]

On Petition for Rehearing, petitioner called to the court's attention a decision of the Court of Claims which had been rendered during the pendency of the ap-

peal in the instant case. That decision, *American Potash & Chemical Corporation v. United States,* 399 F. 2d 194 (Ct. Cl. 1968), on rehearing 402 F. 2d 1000 (1968), held that §334(b)(2) did not pre-empt the *Kimbell-Diamond* doctrine and therefore was not the exclusive mechanism for avoiding the carryover basis rules which apply to normal liquidations of subsidiaries. Petitioner argued that in the instant case, as in *Kimbell-Diamond,* the transactions were in substance purchases of assets and the intermediate steps of purchasing stock and liquidation should be disregarded. As such, the transactions should not be governed by §§332 and 334. Rather, petitioner should acquire a cost basis for the assets under §1012 of the Code, irrespective of the technical requirements of §334(b)(2). In denying petitioner's petition, the Ninth Circuit leaves the question of carryover vs. cost basis dependent solely on compliance with the technical requirements of §334(b)(2), contrary to the Court of Claims. [See Appendix E, *infra.*]

Reasons for Granting the Writ.

A. The Lower Courts' Decisions Herein Denying a Stepped-Up Basis Because of a Non-Compliance With Section 334(b)(2) Are in Conflict With the Reasoning of the Court of Claims.

The first and most important point which petitioner urges involves a conflict in principle between the lower courts' decision in this case and the recent Court of Claims case referred to previously, *American Potash & Chemical Corp. v. United States.* In the instant case, petitioner was denied a cost basis for the assets received upon immediate liquidation of three newly purchased corporations, for alleged failure to comply with the pre-

cise requirements of §334(b)(2). That section provides a limited statutory exception to the normal rules applicable to the liquidation of subsidiaries. But under the *American Potash* case, non-compliance with §334(b)-(2) was deemed irrelevant, if it can be shown that the transaction is in substance a purchase of assets under the well-known *Kimbell-Diamond* doctrine.[7]

The *Kimbell-Diamond* doctrine developed prior to the adoption of the 1954 Code and §334(b)(2). In reality, it was merely an application of the long-established, principle that the substance of a transaction, rather than its form, controls its tax consequences. Where a taxpayer purchased the stock of a corporation and liquidated it with the intention and purpose of acquiring its assets, the economic effect of the transaction, so far as the purchaser was concerned, was the same as a direct purchase of the assets. If the purchaser bought the assets directly, he would have a basis for them equal to their cost to him under §113(a) of the 1939 Code (the forerunner of §1012 of the 1954 Code). However, because in form the last step of the transaction was a distribution in liquidation of a corporation, it could be contended that the basis for the assets must be governed by the rules applicable to corporate liquidations. The tax free liquidation of a subsidiary required the parent corporation to carry over the subsidiary's old basis for the assets under §§ 112(b)(6) and 113(a)(15) of the 1939 Code (the forerunners of §§332 and 334(b)(1), respectively). In order to tax such transaction in accordance with its substance and economic reality, the courts determined that the various steps must be combined and viewed as a single transac-

[7]See footnote 1, *supra*.

tion, amounting to a purchase of assets; the intermediate steps of purchasing stock and liquidating the corporation must be disregarded and given no independent tax effect, leaving the purchaser's basis for the assets to be determined by their cost under §113(a), rather than under the liquidation sections.[8]

Section 334(b)(2) added to the liquidation sections of the 1954 Code a statutory exception to the rule requiring a carryover basis upon liquidation of a subsidiary, based on the *Kimbell-Diamond* principle. However, the statutory exception was made dependent upon certain objective standards. In the *American Potash* case, the Court of Claims was presented, for the first time in any litigated case known to petitioner, the question of whether Congress' adoption of §334(b)(2) pre-empted the *Kimbell-Diamond* doctrine, so that compliance with its precise technical requirements was mandatory in order to avoid a carryover basis in a case which would otherwise fall within the doctrine's rationale. The Court, after reviewing the basis for the doctrine, the limited legislative background and history of the section and some of the many articles written in tax publications dealing with the question, concluded that the *Kimbell-Diamond* doctrine had not been pre-empted and remained fully viable for years governed by the 1954 Code. It was held that Congress' intent

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[8]In addition to *Kimbell-Diamond Milling Co. v. Commissioner, supra,* see *Commissioner v. Ashland Oil & Refining Co.,* 99 F. 2d 588 (6th Cir. 1938), cert. den. 306 U.S. 661; *Georgia-Pacific Corp. v. United States,* 264 F. 2d 161 (5th Cir. 1959); *United States v. Mattison,* 273 F. 2d 13 (9th Cir. 1959); *United States v. M. O. J. Corporation,* 274 F. 2d 713 (5th Cir. 1960), Acq. 1960—2 C.B. 462; *The South Bay Corp. v. Commissioner,* 345 F. 2d 698 (2nd Cir. 1965); *Kanawha Gas & Utilities Co. v. Commissioner,* 214 F. 2d 685 (5th Cir. 1954).

was merely to establish a precise rule under which a taxpayer could proceed assured that the cost basis of the stock acquired to obtain the assets would become the basis of the assets when received in the subsequent liquidation. But this would not prevent a taxpayer from demonstrating other factual circumstances wherein the *Kimbell-Diamond* doctrine has been or should be applied.

In *American Potash,* the taxpayer did not comply with the provisions of §334(b)(2) because the stock of the liquidated corporation was acquired over a period of 14 months, rather than the requisite 12 months. After holding that the taxpayer could nevertheless rely on the *Kimbell-Diamond* doctrine, the court remanded the case to the Trial Commissionr to determine the presence or absence of the necessary factual circumstances to invoke the doctrine.[9]

The instant case, at the most, involves a purely technical and inadvertent non-compliance with §334(b)(2). It was only the lower court's conclusion (still disputed) that the statutory definition of "purchase" had not been met—because of the attribution problem—that petitioner was unable to show strict compliance. Substantively, it is difficult to imagine a clearer situation in which the rationale of the *Kimbell-Diamond* doctrine would be applicable, when the transactions in question are examined in the light of the Tax Court's own findings. It is abundantly clear that, regardless of form, in

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[9]In so doing, the Court of Claims noted, without deciding, that the fact that the acquired corporation had been operated as a subsidiary for seven months might affect the application of the *Kimbell-Diamond* doctrine. No such problem is presented in the instant case because the acquired corporations were liquidated immediately so that their existence as "subsidiaries" was truly nothing more than a transitory step.

substance the petitioner purchased assets. The purchases were from individuals who did not have actual control of petitioner, either individually or in combination, and the price paid represented the true value of the assets. Had the asset purchases been carried out directly instead of by stock purchase and liquidation, the asserted existence of the unrelated Manchester partnership for attribution purposes would have been totally immaterial. Indeed, even if the direct purchase of assets had been from a truly related party, instead of one merely created artificially by strained statutory construction, such relationship would not have prevented petitioner from being entitled to its cost basis under §1012.

The contrast between *American Potash* and the lower courts' decisions in the instant case will undoubtedly have a significant impact on the future administration of cases in which the frequently used *Kimbell-Diamond* device is relied upon by corporate taxpayers seeking to acquire the assets of other corporations. What will be the effect of an attempt to comply with §334(b)(2) which later proves to be inapplicable because of an unforseen technicality which has no substantive effect on the true nature of the transaction? Here, the problem was that a totally unrelated and apparently innocuous partnership, long dormant and all but forgotten, twice prevented an actual purchase from being deemed a statutory "purchase." Other unforseen technical failures can be envisioned.

Under *American Potash*, such failures would not be fatal, assuming the necessary subjective intent to purchase assets could be shown. But under the decisions in this case, technical non-compliance, no matter how

irrelevant it is to the substantive and economic effect of the transaction, is devastating. The transitory existence of the "subsidiary" corporation, no matter how short in duration, is given separate tax significance creating an unexpected and grossly unfair artificial tax burden for the purchaser. The nature of these transactions is such that the potential difference in tax liability can be enormous, as it was here (in excess of $1,000,000).

It is submitted that the *American Potash* case should be adopted as a correct construction of the scope of §334(b)(2), rather than the hypertechnical reasoning of the lower courts in the instant case. Section 334(b)(2) should be regarded as nothing more than a statutory procedure available to a taxpayer which liquidates a newly acquired corporation at any time within two years, in order to be assured of a new cost basis for the assets acquired in this fashion without having to show subjective intent to purchase them in the first place.

In adopting this rule, Congress certainly did not intend to legislate out of existence the concept that in every case substance prevails over form for tax purposes, so that intermediate steps in a unitary transaction would thereafter be given separate tax signifance bearing no relationship to the realities of the situation. The rationale of *Kimbell-Diamond,* if applicable to the facts, should always be available to a taxpayer to avoid the impact of the carryover basis rule, because in substance there is no liquidation of a subsidiary within the meaning of §§332 and 334(b)(1).[10]

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[10]It should be noted that the *Kimbell-Diamond* doctrine applies to purchases of corporate stock and liquidation to acquire assets by individuals as well as corporations. *Ruth M. Cullen,* 14 T.C. 368 (1950), Acq. 1950-2 C.B. 1; *H. B. Snively,* 19

In short, the question presented by this case is whether form will control the effect of an attempt to purchase assets in this fashion (strict reliance on §334(b)(2), as in the decisions in the instant case) or whether the substance of the transaction will still be given effect, as it was under *Kimbell-Diamond* and *American Potash*.

B. The Lower Courts' Decisions Herein Are in Conflict With Other Appellate Decisions on the Question of When a Sale of Partnership Assets Constitutes a Sale of the Partnership Interest in Capital and Profits.

Prior to the decisions of the lower courts in the instant case, it was settled that a single sale of all of the assets of a partnership, after which the partnership no longer engaged in any business enterprise, is to be treated for tax purposes as a sale of the entire partnership interest in capital and profits. *Barran v. Commissioner*, 334 F. 2d 58, 64-65 (5th Cir. 1964) Rev'g 39 T.C. 515; *Hatch's Estate v. Commissioner*, 198 F. 2d 26 (9th Cir. 1952); *Thornley v. Commissioner*, 147 F. 2d 416 (3rd Cir. 1945). From this, it follows that such a sale of the entire partnership interest results in an immediate "termination" of the partnership for purposes of partnership taxation under §708(b)(1)(B) of the Internal Revenue Code; it would also seem to require a termination under §708

T.C. 850 (1953). Section 334(b)(2), on the other hand, applies only to purchases by a corporation. The Court of Claims, in *American Potash*, noted that Congress expressly declined to extend the scope of §334(b)(2) to individual purchasers. The Court concluded Congress could not have intended to pre-empt the use of *Kimbell-Diamond* by corporate purchasers while leaving it available to individuals in post-1954 tax years. As for the apparent viability of *Kimbell-Diamond* for individual purchasers in post-1954 tax years, see *Griswold v. Commissioner*, 400 F. 2d 427 (5th Cir. 1968), aff'g 45 T.C. 463 (1966).

(b)(1)(A). *James, et al. v. United States,* 63-1 U.S.-T.C. Para. 9478 (D.C. Ga. 1963); *Cf. Barran v. Commissioner, supra.* See also, Regulation §1.708-1 (b). Patently, a terminated partnership under §708 cannot still be viable under §318.[11]

In answer to the foregoing contention by petitioner, the Ninth Circuit's opinion in the instant case attempted to distinguish the *Hatch* and *Barran* cases. [App. A, 13-14.] We submit that the grounds urged for such distinction are irrelevant. The court's emphasis on the fact that those cases involved sales of a "going business," whereas Manchester's business had ceased to actively operate several months prior to the sale, misses the real point. In the instant case, just as in *Hatch* and *Barran,* assets which comprised the entire partnership business were sold in a single sale to an unrelated party which desired to take over and operate such business. Thereafter, Manchester no longer engaged in any business. Thus, the material facts are squarely within the rationale of *Hatch's Estate* and *Barran.* It makes no difference whatever that the partnership was forced, for financial reasons, to shut down operations before the assets were sold. It still sold a "business," rather than isolated assets.

We do not find anything in the *Barran* case to justify the court's statement that after the sale there, no payments were paid to the partnership but cash was paid directly to the individual partners. The only monthly payments to the individual partners to which we

[11]The converse is not necessarily true, however. A partnership should not have to be finally terminated under §708 (which is expressly limited to subchapter K) to lose its viability under §318. The purposes of the statutes are not the same. See discussion in section C, *infra.*

find reference in the opinions of the Tax Court and Court of Appeals were for separate covenants not to compete, signed by each of the partners in their individual capacity. There was also an unpaid balance of the purchase price for the partnership's assets after the sale date, but neither of the opinions indicated how such money was paid. The contract of sale recited that the money would be paid *to the partnership*. In any event, it is clear from the context of both *Barran* and *Hatch's Estate* that the precise technical manner in which the payment of the sale price is made, whether directly to the individuals or in the name of the partnership followed by distribution, has nothing to do with the principle on which those decisions are based.

In both *Hatch's Estate* and *Barran* some minor assets and cash were retained in the name of the partnership for some period after the sale. Failure to immediately liquidate and distribute these assets to the individual partners did not prevent the sale from operating to terminate the partnership. The question is, what was the intent of the parties as shown by the substance of the transaction. If they did not intend to carry on as a partnership after the sale of their assets, such sale is regarded as a sale of their interests in the partnership, terminating the partnership. There has never been any doubt that the partners in Manchester did not intend to carry on any further partnership business when, on March 1, 1961, they sold the *entire assets* of the partnership. They did not retain any assets for subsequent liquidation, as was true in *Hatch* and *Barran*. They did no more than collect and distribute the proceeds from the sale.

In principle, the instant case is squarely in conflict with *Barran, Hatch* and *Thornley*. In substance, there

was a sale of the entire partnership interest, and the lower courts' emphasis on the form of the transaction was erroneous as a matter of law.

Except in the instant case, no appellate court has been called upon to apply the rationale of *Barran, Hatch* and *Thornley* in the context of its effect on partnership termination under §708. This will be a recurring problem since partnerships often come to an end as the result of a single sale of assets. The rule adopted by the Ninth Circuit for determining whether the partnership terminates on the date of sale—whether the partnership was actively operating the business just prior to the sale—is utterly illogical and irrelevant and would produce unfair results, as it most certainly did here. Other courts will either have to accept the Ninth Circuit's *non sequitur* reasoning or be in open conflict with this case.

C. The Lower Courts' Construction of the Term "Partnership" in Section 318 Ignores the Sine Qua Non for Constructive Ownership.

The term "partnership," as used in §318 of the Internal Revenue Code, is not defined in the statute or the Treasury Regulations adopted pursuant thereto. Nor is there any determination of the question presented here, other than the Tax Court's earlier decision in *J. Milton Sorem, supra,* on which both lower courts relied in the instant case. But neither the Ninth Circuit nor the Tax Court has seen fit to discuss the underlying purposes for constructive stock ownership through partnerships under §318, or reconcile their decisions with those purposes. Instead, they adopt an unnecessarily myopic, mechanical view that partnership

existence for *any* purpose, no matter how limited, is sufficient, stating their unwillingness to add so-called "judicial gloss" to an already complex section of the Code. [App. A, 16; App. B, 79-80.] Worse yet, the Ninth Circuit expressly disavowed the only conceivable rationale for partnership attribution.

Congress deemed it appropriate to attribute stock owned by a partner to his partnership for certain purposes because of the existence of a relationship of *agency* between them under partnership law. Likewise, the attribution of stock owned by a partnership to its partners in proportion to their partnership interests is derived from the principle of *beneficial ownership,* inherent in this form of legal relationship. See, 2 U.S. Code Congressional and Administrative News, 1964, pp. 3401-3404 (reprinted in part in Appendix D, *infra*); Mertens, Law of Federal Income Taxation, Code Commentary, Ch. 1, Subch. C, pp. 114-127. Obviously, therefore, when these relationships are terminated under partnership law, there is no longer a "partnership" within the meaning and purpose of §318, regardless of whether the partnership has yet been formally terminated and liquidated.

Under partnership law, the agency relationship terminates immediately upon "dissolution" and prior to "termination" of the partnership, as to all matters which are not related to winding up the partnership affairs. There is no agency or beneficial ownership as to new matters. Dissolution does not require formal action and is accomplished by any act which is inconsistent with the continuation of the partnership. In Manchester's case, the agency relationship terminated as to all new matters on March 1, 1961, the date of

the sale of its entire business assets. The cessation of business and sale of its assets in connection with the hospital venture—the only venture for which Manchester was formed—was unquestionably a "dissolution." Thereafter, even if it is deemed to have had a continued limited existence to wind up its affairs, there was absolutely no legal relationship among the parties which would support a conclusive presumption of stock attribution from one former partner to another through Manchester when the stock of petitioner was subsequently issued on June 23, 1961, or when petitioner purchased the stock of Old Baker and Kerman Tallow on June 26, 1961, and Veronica on Dec. 20, 1962.[12]

The Ninth Circuit rejected this argument, stating: "Assuming for purposes of argument that the agency relationship did cease, the argument is without merit for the attribution rules of §318 are not dependent upon the existence of any agency relationship between the parties or entities." [App. A, 15.] It is submitted that such interpretation is totally erroneous and that the existence of the legal relationship of agency is a *sine qua non* for partnership "existence" within the

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[12]The Ninth Circuit's brief discussion of California Partnership Law is inaccurate and completely misses the point. Termination of the agency relationship as to new matters after dissolution is a fundamental rule of partnership law under both California law and the uniform partnership act. See, *e.g., Credit Bureau, Inc. v. Beach,* 144 Cal. App. 2d 439, 443, 301 P. 2d 87 (1956); *Maryland Casualty Co. v. Little,* 102 Cal. App. 205, 211, 282 Pac. 968 (1929); 38 Cal. Jur. 2d., Partnership, §107, pp. 22-23; 40 Am.Jur. Partnership §264, pp. 312-313. As for the point that dissolution was caused by the cessation of business and sale of assets, after which Manchester carried on no other business, see *Middleton v. Newport,* 6 Cal. 2d 57, 56 P. 2d 508 (1936); *Pilch v. Milikin,* 200 Cal. App. 2d 212, 19 Cal. Rptr. 334 (1962); *Maryland Casualty Co. v. Little, supra;* 40 Am. Jur., Partnership, §243, p. 229.

meaning and purpose of §318. The Ninth Circuit's interpretation will require final termination and liquidation before a partnership can cease to exist for attribution purposes. In cases involving an installment sale of the partnership's business, such as occurred in the instant case, it may be several years before all of the proceeds are collected and distributed. In the meantime, each of the former partners will be unable to enter into any subsequent unrelated business venture in which he acquires corporate stock without such stock being deemed constructively owned by his partnership. Such result is both illogical and unjust, serving no legitimate purpose, and will undoubtedly cause serious hardships which Congress did not foresee or intend.

This Court should review this question and adopt an interpretation of §318 which is more reasonable and consistent with Congressional intent.

D. The Lower Courts' Construction and Application of Sections 318 and 334(b)(3)(C) Cannot Be Reconciled With Congressional Objectives.

The clear objective of Congress for §334(b)(3)(C) of the Internal Revenue Code is to prevent possible tax avoidance by denying the benefits of §334(b)(2) in cases where a parent corporation acquires the stock of a subsidiary from its own controlling stockholder. This objective is accomplished by defining the term "purchase" as excluding acquisitions from a person whose stock is attributable to the acquiring corporation under §318. Stock is attributable to a corporation under §318(a)(2)(C) only from a person who owns 50% or more in value of such corporation's stock. A purchase by such corporation from such a person

would not be an arm's length transaction, and the price paid for the stock might well be greater than the fair market value of the assets. Moreover, the person selling the stock to his controlled corporation is, in some respects, merely transfering his corporate investment from one pocket to another and paying himself with his own money. In such case, he should not be able to create an artificial step-up in the basis for the underlying business assets.

In the instant case, no person in fact owned 50% of petitioner's stock, nor did the sellers even own that much in combination. Even more important, the Tax Court's findings expressly negated the reasons for §334(b)(3)(C)'s statutory denial of a stepped up basis by finding that the Jerome brothers did not actually have direct or indirect majority ownership or control of petitioner, and all dealings were entirely bona fide and at arm's length with the prices negotiated being fair. [App. B, 59-64.]

In view of these findings, the lower courts' construction and application of §§318 and 334(b)(3)(C) produced an anomaly which Congress could not possibly have anticipated. Indeed, Congress itself amended §318 in 1964 to eliminate mere double attribution, being the attribution of stock from one partner to his partnership and out again to the other partners. In so doing, Congress expressly recognized that there was no economic or other justification for this combination of rules. 2 U.S. Code Congressional and Administrative News 1964, pp. 3401-3404. [App. D, *infra.*] Yet, in this case, the courts have approved tripple applications of the rules, from partner to partnership, out to another partner, and then again to a second partner-

ship *in which the actual owner of the attributed stock had absolutely no interest.* Moreover, the courts had to employ this process through two unrelated intermediate partnerships (one of which, Manchester, had actually been dissolved, as we pointed out previously) in order to create the absurd conclusive presumption (overcoming the actual findings) that the Jerome Brothers Partnership, which actually owned none of petitioner's stock, was nevertheless unable to deal with petitioner at arm's length by virtue of 51.5% constructive ownership from these diverse sources.

Furthermore, as noted previously, in the case of the 1962 transaction, the stock of Veronica was not even purchased from the Jerome Brothers Partnership. It was owned by the brothers in their individual capacities. Petitioner is baffled as to how the stock of Veronica could be deemed to have been acquired from any "person" having even constructive ownership of 50% of petitioner.[13] There is no basis for combining the ownerships of separate sellers to make §§318 and 334(b)(3)(C) applicable. *Stevens Pass, Inc.*, 48 T.C. 532, 539 n. 5 (1967). Yet, that is precisely what the Ninth Circuit and Tax Court have done here. It is not clear whether the courts' reasons were that because the Jeromes had a partnership, the sale must be attributed to such partnership (even though no contention was ever made that the sale was other than by the three individuals), or simply that they were co-sellers in a single transaction. In either case, these decisions represent a totally unwarranted interpretation of the statute which may severely limit the availability of §334(b)(2).

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[13]See footnote 5, *supra.*

Of course, it is recognized that this incredible miscarriage of the legitimate purpose behind §334(b)(3)-(C) is no longer possible under the aggravated set of circumstances present here because of the 1964 amendment to §318.[14] But it is still possible, using the rationale of these decisions, to create a "person" whose stock is attributable to an acquiring corporation under §318, entirely by virtue of 50% *constructive ownership,* derived from an application of one or more of the other attribution rules; or by simply combining the interests of several sellers. We submit that such result cannot be reconciled with the purpose behind §334-(b)(3)(C). That section should be limited to transactions in which stock is acquired from a *single person* whose stock is attributable to the acquiring corporation under §318 by virtue of 50% or more *actual ownership;* or at least the employment of constructive ownership should include only relationships which, under the particular circumstances, could actually prevent arm's length dealing.[15]

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[14]Section 318(a)(5)(C) now expressly prevents double attribution of the same stock, from partner to partnership and back out to other partners. The Ninth Circuit refused to accept petitioner's contention that this 1964 amendment was an expression of Congress' recognition that double attribution was neither justified nor intended under the rationale for §318 and, therefore, that the multiple attribution applied by the Tax Court here should be disapproved by statutory construction even for years prior to 1964. The Court of Appeal's decision leaves petitioner with the dubious distinction of being the only taxpayer known to us which ever has been, or will be, penalized by multiple reattribution. Congress' failure to rectify this acknowledged defect in the wording of the statute until 1964 (neglecting to state that the change was retroactive) will cost petitioner over $1,-000,000 in additional taxes and interest.

[15]In contrast with the result here, the courts, for purposes of determining whether a stock redemption is the equivalent of a dividend, have refused to rely entirely on the attribution rules incorporated into §302 and have looked for actual control, beyond

Conclusion.

For the foregoing reasons, this petition for writ of certiorari should be granted, to eliminate conflicting decisions, to settle important questions of tax law and to prevent a manifest injustice to this taxpayer.

Respectfully submitted,

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the mere mathematical percentages of ownership created by the literal application of §318. See, *Himmel v. Commissioner*, 338 F. 2d 815, 820 (2d Cir. 1964); *Est. of Arthur H. Squier*, 35 T.C. 950, 955-956 (1961); *Herbert C. Parker*, 20 T.C.M. 893, 900 (1961).

APPENDIX A.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals, for the Ninth Circuit.

Baker Commodities, Inc., a California Corporation, Appellant, vs. Commissioner of Internal Revenue, Appellee. No. 23,019.

[August 8, 1969]

Petition to Review the Decision of the Tax Court of the United States

Before: BARNES and CARTER, Circuit Judges, and BYRNE,* District Judge.

JAMES M. CARTER, Circuit Judge:

This is an appeal from a decision of the Tax Court, 48 T.C. 374 (1967), in which the appellant corporation was denied a stepped up basis for assets acquired from the liquidation of three subsidiary corporations, i.e. that appellant was not entitled to use as its basis for the assets received from the subsidiary corporations in liquidation, the same amount that was paid for the stock of these corporations, but that it must use as its basis for the assets received, the same basis they had in the hands of the subsidiary corporations before liquidation. The Tax Court held that appellant was not entitled to § 334(b)(2)[1] basis treatment of

*Hon. William M. Byrne, Senior United States District Judge, Central District of California, sitting by designation.

[1]All references are to the Internal Revenue Code of 1954. The same sections are contained in 26 U.S.C. 1964 ed. with the same section numbers.

assets thus transferred, since the stock in the subsidiary corporations was acquired from "a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock." § 334(b)(3)(C).[2] We affirm the decision of the Tax Court.[3]

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[2]334(b)(2), (3) and (4), as it was during the years at issue in this case:

"(2) Exception.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—

(A) the distribution is pursuant to a plan if liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a period of not more than 12 months, then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) Purchase defined.—For purposes of paragraph (2)(B), the term 'purchase' means any acquisition of stock, but only if—

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),

(B) the stock is not acquired in an exchange to which section 351 applies, and

THE QUESTIONS PRESENTED

There are two issues to be disposed of in this appeal: (1) whether so-called "sidewise" attribution was provided for by § 318 prior to its amendment in 1964, (Pub. L. 88-554, § 4(a), 78 Stat. 761); and (2) whether a partnership which has sold and transferred all of its assets in return for a promissory note and is collecting payments on the note and distributing the proceeds to the partners is in existence for purposes of § 318 attribution rules.

THE FACTUAL BACKGROUND

There is no dispute as to the facts. In January 1951, Frank, Varney and Paul Jerome executed a formal partnership agreement for their business, which was known as Jerome Brothers; it has continued to exist up to the filing of this appeal.

As of March 1961, the Jerome Brothers partnership owned all of the issued and outstanding stock of Baker Commodities, Inc. (hereinafter OLD BAKER), a California corporation; all of the issued and outstanding stock of Phoenix Tallow Company, an Arizona corporation; 50% of the issued and outstanding stock of Ker-

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(C) the stock is not acquired from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock.

(4) Distributee defined.—For purposes of this subsection, the term 'distributee' means only the corporation which meets the 80 percent stock ownership requirements specified in section 332(b)."

[3]The decision of the Tax Court was also based in the alternative on 26 U.S.C. § 334(b)(3)(B), (see note 1, supra) that the stock of two corporations was acquired "in an exchange to which section 351 applies . . .". We do not here pass on this basis of the Tax Court decision and express no opinion on whether it was erroneous.

man Tallow Works, a California corporation; and 50% of the issued and outstanding stock of San Joaquin Packing Company, a California corporation. These entities were principally engaged in the business of rendering animal meat by-products into animal feedings fats and inedible tallow. The partnership also owned certain pieces of real property used in connection with the rendering and tallow business. The partnership also conducted business under fictitious names. In the Albuquerque, New Mexico area the partnership operated under the fictitious name of Atlas Rendering Company. In the area of Honolulu, Hawaii, it operated under the fictitious name of Pacific Rendering Company. In the Los Angeles area it operated under the fictitious name of Star Processing Company.

In the late 1950's, the Jeromes began informal discussions with seven key employees in their rendering business.

On May 14, 1956, a California corporation was organized under the name American Extraction Company, but it remained dormant until May 2, 1961, at which time its name was changed to Jerome Brothers. On June 9, 1961, an application was filed by Jerome Brothers for a permit to issue its stock, to the following individuals to the extent of ten percent thereof to each. Frank Jerome, Paul Jerome, Varney Jerome, Stephen Frank Shultz, Louis J. Frederick, Walter A. Sanderson, James M. Andreoli, Laverne A. Nelson, J. E. Rickert and Jack G. Keith. Subsequent to the issuance of the permit, each of the ten individuals made a contribution of $500.00 and acquired ten percent of the issued and outstanding stock of Jerome Brothers. The name of this corporation was later changed to Baker

Commodities, Inc. (hereinafter NEW BAKER). Each of said individuals have at all times since that date been owners of record of ten percent of the issued stock of New Baker.

After the stock was issued by New Baker and on June 26, 1961, a contract was entered into between the Jerome Brothers partnership, New Baker and the individual stockholders of New Baker. Under the agreement, New Baker acquired from the Jerome Brothers partnership: all of the issued and outstanding stock of Old Baker; all of the issued and outstanding stock of Phoenix Tallow Company; the partnership's 50% of the issued and outstanding stock of Kerman Tallow Works; the partnership's 50% of the capital stock in San Joaquin Packing Company, together with certain pieces of real property.

At the same time, and by agreement dated June 26, 1961, New Baker and its stockholders entered into an agreement with the R. S. Wilson Company, a California corporation, under which New Baker purchased the remaining 50% of the issued and outstanding capital stock of Kerman Tallow Works and San Joaquin Packing Company.

Between June 26 and June 30, 1961, New Baker by proper resolution adopted a plan of liquidation for both Kerman Tallow Works and Old Baker. The liquidations were carried out and the assets of the corporation were distributed to New Baker in cancellation of its stock. Cost of the stock cancelled in the liquidations was apportioned to the assets transferred pursuant to § 334 (b) (2).

A Panamanian corporation, known as Veronica Compania Naviera S.A., was organized by Frank, Paul and

Varney Jerome, on or about August 15, 1956. The purpose of the corporation was to engage in the chartering and operation of ocean going vessels. As of the month of December, 1962, all of the issued and outstanding capital stock of Veronica was owned by Frank, Paul and Varney Jerome in equal interests. It had been actively engaged in business at all times since its organization.

By agreement dated December 20, 1962, New Baker acquired all of the issued and outstanding stock of Veronica from the Jerome brothers.

On or before December 31, 1962, Veronica was liquidated pursuant to the laws of the Republic of Panama and all of its assets and liabilities, including an agreement with a Philippine corporation known as Le-Gaspi giving Veronica an exclusive right to market the products produced by such Philippine corporation, were transferred to New Baker. The purchase price of $1,100,-000 paid for Veronica stock was allocated to the assets received by New Baker upon the liquidation in accordance to § 334(b)(2).

At all times during the years in question, Keith Engineering Company conducted a going business as a general partnership. Jack G. Keith owned a 50% interest, and Frank, Paul and Varney Jerome each owned a 16⅔% interest.

Manchester Medical Hospital, a limited partnership (formerly Morningside Convalescent Hospital), hereinafter called "Manchester" was created on or about January 1, 1958 for the sole purpose of constructing, owning and operating a convalescent hospital. Immediately prior to March 1, 1961, each of the Jerome brothers was a general partner of Manchester, and each owned

11.11% of the proprietary interest. Five persons—James Andreoli, Louis Frederick, Laverne Nelson, Walter Sanderson and S.F. Shultz—were limited partners each with a 4.17% interest; each also owned 10% of New Baker.

A convalescent hospital was in fact built and operated by Manchester; however, it ran into severe financial difficulties and was shut down in July 1960. On March 1, 1961, the partners sold all of the assets of the partnership to Southwest Community Hospital Association, a nonprofit corporation, hereinafter referred to as "Southwest", which was unrelated to any of Manchester's partners or any of the parties or entities involved in this action. Southwest gave a prommissory note for the purchase price which was secured by a chattel mortgage and deed of trust on the hospital property.

Information returns were filed by Manchester for fiscal years 1961 and 1962. The 1961 return reported the sale of assets; the 1962 return, for the fiscal year ending August 31, 1962, reported collections on the installment sale of $36,623.97. No other receipts or income were shown on the 1962 return; however, the note from Southwest was shown as an asset with an amount due of $12,500.00.

A lawyer whose firm performed services for Manchester testified his files showed that a "Satisfaction of Chattel Mortgage" was drafted for Manchester's use in February 1962. However, there was no further testimony or offer of evidence that it had ever been executed. Further, other than evidence of the partnership's discontinuance of the hospital operation in 1960 and its sale of assets in 1961, no proof was offered of any final liquidation and distribution prior to December 31, 1962.

THE TAX COURT'S APPLICATION OF SECTION 318(a)

For a liquidation of a subsidiary corporation to be afforded treatment under § 334(b)(2), the stock acquired in the subsidiary must have been acquired by "purchase." "Purchase" is defined in § 334(b)(3); one transaction which is not classified as a "purchase" is one in which stock is acquired by the parent corporation from "a person the ownership of whose stock would, under § 318(a), be attributed to the "purchaser."

In this case the Tax Court first attributed 51.5% of New Baker to Jerome Brothers partnership, with the result that everything the partnership owned was attributed to New Baker. Thus, the partnership's ownership in Veronica, Old Baker and Kerman was attributed to New Baker. At the time of the transactions, § 318(a) provided in part as follows:

> "(2) Partnerships, estates, trusts, and corporations.—
>
> (A) Partnerships and estates.—Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.
>
> . . .

(C) Corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

(i) such person shall be considered as owning the stock owned, directly or indirectly, by or for that corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation; and

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

. . .

(4) Constructive ownership as actual ownership.—

(A) In general.—Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3), be treated as actually owned by such person."

30% of New Baker was attributed to the Jerome Brothers partnership, since each brother owned 10% of New Baker. Appellant does not question this application of § 318(a).

Jack Keith owned 10% of New Baker at the time of the transactions and was also an owner of 50% in the partnership Keith Engineering Company; the Jerome Brothers owned the other 50%. Since all stock owned by a partner is deemed to be owned by the partnership and all stock owned directly or indirectly by a partnership is deemed to be owned proportionally by its partners, 5% of New Baker was attributed to the Jerome Brothers partnership from Keith Engineering.

The brothers as individuals each owned 11.11% of a limited partnership, Manchester Medical Hospital at the time of the transactions. Five other partners in Manchester each owned 10% of New Baker. Applying the same rules as with Keith Engineering, 16.5% of New Baker was thus attributed from Manchester to Jerome Brothers partnership.

After the foregoing application of § 318(a), the Tax Court found that Jerome Brothers partnership owned 51.5% of New Baker; therefore, the partnership's ownership of Veronica, Old Baker and Kerman was then attributed to New Baker and § 334(b)(3)(C) was applied.

1. *"Sidewise" Attribution.*

Appellant contends that once Keith's 10% was attributed to Keith Engineering, and once the 50% owned by the five individuals was attributed to Manchester, that interest thus attributed could not then be reattributed to the Jerome brothers and then to the Jerome Brothers partnership. Appellant contends that § 318(a) was not intended by Congress to be applied in that manner to provide for this "sidewise" attribution. It points to § 318(a)(5)(C) as amended in 1964, that provision states the following:

> "Stock constructively owned by a partnership . . . shall not be considered as owned by it . . . in order to make another the constructive owner of such stock."

The amendment with exceptions not pertinent here, was prospective only in its operation, Section 4(c) of Public Law 88-54, and appellant so concedes, but it contends that the amendment expresses the intent of Congress as to the operation of § 318 prior to the

amendment. It cites us to no authority for this contention.

Upon examination of the statute as it existed at the time of the transactions and of scholarly writing on the subject, we hold that the Tax Court correctly applied § 318(a) in this case. Loeb, *What Constitutes Ownership of Stock,* 21 N.Y.U. Fed. Tax Inst. 417, 431-32 (1963); Ringel, Surrey and Warren, *Attribution of Stock Ownership in the Internal Revenue Code,* 72 Harv. L. Rev. 209, 220 and 261 (1958).

2. *Existence of Manchester.*

Appellant concedes that Keith Engineering Company was in existence at the time of the transactions in 1961 and 1962; however, it contends that Manchester ceased to exist for purposes of § 318 attribution rules when it sold its convalescent hospital in March 1961.

§ 318 does not define "partnership"; the general definition of "partnership" set forth in § 7701, I.R.C., should apply. *Loeb, What Constitutes Ownership of Stock,* 21 N.Y.U. Fed. Tax Inst. 417, 424-25 (1963). § 7701 provides in part:

> "(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—
>
> . . .
>
> (2) Partnership and partner.—The term "Partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization."

[The same definition appears in § 761 of Subchapter K, 26 U.S.C., which deals with the taxation of partnership income.] When determining the character of an organization for the purposes of federal taxation "the classes into which organizations are to be placed for purposes of taxation are determined under the Internal Revenue Code." Reg. § 307.7701-1(c). Also, the term "partnership" is not "limited to the common-law meaning of" the term, "but is broader in its scope and includes groups not commonly called partnerships." *Id.* Although determining whether a partnership exists is a federal question, local law[4] applies when determining the legal relationships between persons:

> ". . . local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters as the legal relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization in its assets." *Id.*

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[4]Appellant cites California cases and argues that the agency relationship between the partners was dissolved on March 1, 1961 when the assets of Manchester were sold. All of the cases cited by appellant on this subject are inapplicable to the facts of this case, either because they were prior to the adoption by California of the Uniform Partnership Act. (Stats. 1949, c. 383, p. 674) or dealt with questions as to whether a particular partner was part of the partnership agency at a particular time.

Appellant ignores the sections from the California Uniform Partnership Act existing in 1961-1962 and reading as follows in *Calif. Corporations Code:*

> "Section 15029. *Dissolution defined.* The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.
> Section 15030. *Effect of dissolution.* On Dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed."

§ 7701 does not define termination of a partnership for tax purposes, but Subchapter K, in which "partnership" is defined in the same manner as in § 7701, does provide a test for determining when a partnership terminates.

> "(a) General rule.—For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.
>
> (b) Termination.—
>
> (1) General rule.—For purposes of subsection (a), a partnership shall be considered as terminated only if—
>
> (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or
>
> (B) within a 12-month period there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits." I.R.C. § 708(a) and (b).

Appellant contends that the Tax Court erred when it determined that Manchester existed in 1961 and 1962; it cites §708 to support the contention.

Appellant contends that the sale of the hospital by Manchester terminated the partnership because it was a sale of the partners' interest, i.e. "a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." Appellant cites two cases which he contends supports his argument. *Barren v. C.I.R.*, 334 F.2d 58 (5 Cir. 1964) is one of those; it is distinguishable from the case at bar. In *Barren* the court found that: (1) the sale was of a "going

business"; (2) no payments were made to the partnership, but cash was paid directly to each partner at the time of the sale; and (3) the only payments made after the sale was finalized were monthly payments to each partner individually in consideration for individual covenants not to compete. *Hatch's Estate v. C.I.R.*, 198 F. 2d 26 (9 Cir. 1952) is the other case relied upon by the appellant. *Hatch's Estate* is also distinguishable from our case. In *Hatch's Estate* the court noted that the agreement recited that the subject of the sale was "all of the business and assets of Hatch Chevrolet Company, a co-partnership"; the buyer agreed to "operate the business" as his own. Finally, the court found that "it was the expressed intention of the taxpayers to sell their business as a going concern and not just a specified list of their stock in trade." 198 F.2d at 29-30.

In our case the subject of the sale in March 1961 was a convalescent hospital which had been closed down since July of 1960. One note and one chattel mortgage were given by the buyer. The information return for Manchester in 1960 showed a sale of assets and 1961 return showed collections on the note from the buyer Southwest. The 1961 return also showed a balance due on the note of $12,500 as of August 31, 1962. Manchester did not terminate in March 1961 due to a sale of partnership interests; the sale was of assets and not a going business. *Foxman v. Commissioner*, 41 T.C. 535, 557 (1964), affirmed on other grounds 352 F.2d 466 (3 Cir. 1965).

Appellants also contend that under California law the agency relationship between the partners had ceased to exist as of the date of the sale of the hospital in March 1961; therefore, there can be no attribution of ownership through the partnership. Assuming for purposes of argument that the agency relationship did cease, the argument is without merit for the attribution rules of § 318 are not dependent upon the existence of any agency relationship between the parties or entities. See the comments on § 318 prior to amendment in *Senate Report No. 1240,* U.S Code Congressional and Admin. News 3401-3402 (1964).

Appellant finally contends that with the sale of the hospital, the Manchester partnership ceased engaging in its principal business activity; this it contends is a termination under § 708(b)(1)(A). Cessation of a "primary purpose" is not enough under § 708; there must be "a complete cessation of all partnership business." *Ginsburg v. United States,* 396 F.2d 983, 988 (Ct. Cl. 1968).

Even if operations "are limited to winding up the business, the partnership is not considered terminated until the only remaining asset, cash, is distributed to the partners and all other activity ends." *Kinney v. United States,* 228 F.Supp. 656, 663-64 (W.D. La. 1964); affirmed per curiam 358 F.2d 738 (5 Cir. 1966); *Yagoda v. C.I.R.,* 331 F.2d 485, 491 n.5 (2 Cir. 1964), cert. denied 379 U.S. 842 (1964). The appellant has offered no evidence of a final distribution of Manchester partnership assets prior to December 31, 1962.

Since the Manchester partnership was not terminated at the time of the liquidations in this case, it existed for the purposes of applying the attribution rules of § 318. *Sorem v. Commissioner,* 40 T.C. 206, 214-15 n.14 (1963), reversed on other grounds, 334 F.2d 275 (1 Cir. 1964), states:

> "As we view the statute [Section 318], attribution is required by virtue of the mere *existence* of a partnership relation between corporate shareholders, and business activity has nothing to do with it. Certainly sec. 318 itself makes no reference to 'business activity' as a prerequisite for partnership attribution, and in the absence of convincing authority we are unwilling to add this judicial gloss to an already complex section of the Code."

The judgment of the Tax Court is Affirmed.

APPENDIX B.

Opinion of the Tax Court of the United States.

TAX COURT OF THE UNITED STATES

Baker Commodities, Inc., Et Al.,[1] Petitioners v. Commissioner of Internal Revenue, Respondent. 48 T. C. No. 39.

Docket Nos. 1371-65, 5416-65, 5418-65, 5420-65.

Filed June 23, 1967.

In 1961, three brothers transferred their partnership business, consisting of stock in four corporations and real estate, to a corporation owned partly by them and partly by seven employees of the partnership business. In consideration for the partnership assets thus acquired, the corporation assumed partnership indebtedness of $62,000 and issued a $3,150,000, 15-year promissory note to the partnership which required the corporation to make annual payments of interest and principal in the amounts of $80,000 and $200,000, respectively. Immediately after the transfer, the corporation liquidated two of the four corporate subsidiaries acquired thereby and took a stepped-up basis on the assets received from the liquidated corporations. In 1962, the corporation acquired stock in a Panamanian corporation from the three brothers and immediately liquidated it, taking a stepped-up basis on the assets thereby acquired, including an exclusive marketing agreement.

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[1]Cases of the following petitioners are consolidated herewith: Frank Jerome and Helen Jerome, docket No. 5416-65; Varney Jerome and Iva Jerome, docket No. 5418-65; and Paul Jerome and Angelina Jerome, docket No. 5420-65.

Held:

(1) The 15-year promissory note constituted a bona fide indebtedness rather than equity capital investments by the three brothers, and the corporation was entitled to deduct its annual interest payments made on the note.

(2) The stock in the two subsidiary corporations which were liquidated in 1961 was acquired by the corporation in an exchange to which sec. 351, I.R.C. 1954, applied and pursuant to sec. 334-(b)(2) and (b)(3)(B) the corporation was not entitled to take a stepped-up basis on the assets received upon liquidation of those two corporations.

(3) The three brothers were entitled to report as long-term capital gain the gain received on their distributive share of the annual principal payments made by Baker Commodities, Inc., to their partnership.

(4) At the time the corporation acquired stock in the Panamanian corporation in 1962, it was the constructive owner of that stock under the attribution rules of sec. 318(a) and pursuant to sec. 334 (b)(2) and (b)(3)(C), the corporation was not entitled to take a stepped-up basis on the assets received upon liquidation of the Panamanian corporation, including the exclusive marketing agreement.

Carl A. Stutsman, Jr., Jack R. White, and *Glenn M. Alperstein,* for the petitioners.

Arthur P. Generaux, Jr., for the respondent.

WITHEY, *Judge:* Respondent determined deficiencies in petitioners' income tax for the years and in the amounts as follows:

Petitioner	Docket No.	Taxable year ended	Deficiency
Baker Commodities, Inc.	1371-65	6/30/61	$ 57,324.26
		7/31/61	6,946.27
		6/30/62	341,322.69
		6/30/63	182,156.18
Frank and Helen Jerome	5416-65	12/31/61	25,760.93
		12/31/62	305,694.99
		12/31/63	17,774.89
Varney and Iva Jerome	5418-65	12/31/61	25,841.22
		12/31/62	309,338.10
		12/31/63	18,085.06
Paul and Angelina Jerome	5420-65	12/31/61	23,962.26
		12/31/62	309,169.92
		12/31/63	12,695.28

The cases have been consolidated and will be decided together. Numerous issues raised by the pleadings have been disposed of by the parties, leaving the following issues to be decided:

1. Whether the promissory note in the amount of $3,150,000 given to the Jerome Brothers partnership by Baker Commodities, Inc., constituted a bona fide indebtedness, or was rather in the nature of preferred stock evidencing a risk capital investment by the partners.

2. Whether Baker Commodities, Inc., obtained a stepped-up basis on the assets it acquired upon the complete liquidation in 1961 of two wholly owned subsidiaries.

3. Whether the three Jerome brothers were entitled to report as long-term capital gain the gain they realized from their distributive share of the principal pay-

ments received from Baker Commodities, Inc., on the $3,150,000 promissory note.

4. Whether Baker Commodities, Inc., obtained a stepped-up basis on the assets it acquired upon the complete liquidation in 1962 of a wholly owned subsidiary.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

All statutory references hereinafter are to the Internal Revenue Code of 1954 unless otherwise indicated.

Petitioner Baker Commodities, Inc., was duly organized and existed as a California corporation with its principal office in Los Angeles, California. For the tax years in question it filed its corporate income tax returns with the district director at Los Angeles, California.

The petitioners Frank and Helen Jerome are, and were at all times material herein, husband and wife residing in Downey, California. They filed their Federal income tax returns for all years in question with the district director at Los Angeles, California.

The petitioners Varney and Iva Jerome are, and were at all times material herein, husband and wife residing in Phoenix, Arizona. They filed their Federal income tax returns with the district director at Los Angeles, California, for the years 1961 and 1962 and with the district director at Phoenix, Arizona, for the year 1963.

The petitioners Paul and Angelina Jerome are, and were at all times material herein, husband and wife residing in Albuquerque, New Mexico. They filed their

Federal income tax returns for all years in question with the district director at Albuquerque, New Mexico.

Since the wives of the individual petitioners are joined here only by virtue of their filing of joint returns with their respective husbands, use of the word "petitioners," when referring to the individual petitioners as distinguished from the corporate petitioner, will be used only in reference to the respective husbands.

Frank, Paul, and Varney Jerome are brothers who have been equal business partners since 1929 under the name of Jerome Brothers (hereinafter sometimes referred to as the Jerome Brothers partnership or the partnership). Their partnership agreement, although originally oral, was reduced to writing on or about January 1, 1951, and has continued in existence at all times up to and including the time of trial. In its early years, the partnership engaged in the fertilizer business. After discontinuing its fertilizer operations in 1937, it entered the business of rendering animal meat byproducts into animal feeding fats and inedible tallow. One of the most essential aspects of the tallow business is the procurement of raw materials such as meat scraps, fat, and bones. The raw material is obtained from various sources including retail markets, wholesale meat outlets, and packing houses. Since the partnership had no contracts with its sources of supply, procurement of needed raw materials was largely dependent upon personal contacts with its suppliers. While the company had many supplier accounts which were of longstanding duration, and although the company generally enjoyed a good reputation in the industry, it was still required to compete with four or five other companies in the acquisition of its raw materials. No part of the tallow business owned

by the partnership was of a retail nature nor was the company's tallow marketed under any brand name. Approximately 60 percent of the tallow manufactured by the partnership competed in the world market where the price was determined by the market forces of supply and demand.

In 1940, the partnership expanded its tallow and rendering business to Phoenix, Arizona. The business in Phoenix was conducted in the partnership's name until 1946 when it was incorporated under the name of Phoenix Tallow Company (hereinafter Phoenix Tallow). Thereafter, until June of 1961, the partnership owned all of the issued and outstanding stock of Phoenix Tallow. In 1947, the partnership began construction of a plant at Norwalk, California, a suburb of Los Angeles, and from 1947 until June 1961, the partnership engaged in the tallow and rendering business in and around the area of Los Angeles. In 1950, the partnership expanded its business to Kerman, California, where it acquired an interest in two California corporations, Kerman Tallow Works (hereinafter Kerman Tallow) and San Joaquin Packing Company (hereinafter San Joaquin Packing). Until March of 1961, one-third of the stock of Kerman Tallow and San Joaquin Packing was owned by Harold Wardlaw (hereinafter Wardlaw), one-third by the partnership, and the remaining third by the R. S. Wilson Company (hereinafter the Wilson Company), a California corporation wholly owned by Robert S. Wilson. Wilson has been a business acquaintance of the three Jerome brothers since 1947 when, as a broker, he first solicited the partnership's rendering business in the Los Angeles area. In March 1961, Wardlaw's one-third interest in the two cor-

porations was redeemed, leaving the outstanding stock divided equally between the Jerome Brothers partnership and the Wilson Company.

In addition to the foregoing businesses, the partnership owned all of the issued and outstanding stock of Baker Commodities, Inc. (hereinafter Old Baker), a California corporation. Thus, at the beginning of June 1961, the partnership owned 100 percent of the stock in Old Baker and Phoenix Tallow, and 50 percent of the stock in Kerman Tallow and San Joaquin Packing, all of which were principally engaged in the business of rendering animal meat byproducts into animal feeding fats and inedible tallow. The partnership also owned certain pieces of real property used in connection with the rendering and tallow business. In addition, the partnership conducted business under fictitious names. In the Albuquerque, New Mexico, area, the partnership operated under the name of Atlas Rendering Company; in the area of Honolulu, Hawaii, Pacific Rendering Company; and in the Los Angeles area, Star Processing Company.

Beginning in the early 1950's, the three Jerome brothers began considering the problem of perpetuating their tallow and rendering business. They were concerned with the ownership and management of that business after their deaths, and inasmuch as the brothers had no relatives other than each other who were in the top management of the business, they determined to transfer it to a group composed of themselves and seven other men (hereinafter keymen), six of whom were employees of the partnership.[2] The seventh, Jack

[2]The six employees selected by the Jerome brothers to participate in the transfer of the partnership business, together with

(This footnote is continued on the next page)

Keith, owned a consulting engineering company which had, since 1947, done considerable engineering work for the partnership. In 1954, Keith formed a general partnership with the Jerome brothers, Keith owning 50 percent and the remaining 50 percent owned equally by the three Jerome brothers. The nature of Keith's business was thereafter changed from one of consulting and engineering to manufacturing and engineering, with the Keith partnership continuing to do work for the Jerome partnership. The Keith partnership was still in existence as of the time of trial.

In the late 1950's, the three Jerome brothers began to informally discuss with the seven keymen the possibility of transferring to them a part ownership in the partnership's tallow and rendering business. Between 1959 and June 1961, there were several conversations relative to this possibility, at some of which all 10 individuals were present and at others, less than 10 were present. These discussions continued until early 1961 when the Jerome brothers and the keymen began to discuss the specific terms and conditions by which the partnership's business might be sold to the 10 individuals. During the period of these discussions one of the keymen, Andreoli, ordered current appraisals of the fixed assets used in the partnership's tallow and rendering business in order to more accurately determine the value of those assets for the purposes of negotiation.

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their period of association with the business, were the following: Stephen Frank Shultz, employed since 1950; Louis J. Frederick, employed since 1952; Walter Sanderson, employed since 1953; James M. Andreoli, employed since 1951; Laverne A. Nelson, employed since 1951; and J. E. Rickert, employed since 1958. The foregoing employees will sometimes hereinafter be referred to by their last names.

Tait Appraisal Company apprised most of the partnership's assets outside of the Honolulu, Hawaii, area.[3] The assets located in Hawaii were appraised by the General Appraisal Company. Of the 12 Tait appraisals, 11 contained the following explanatory statements:

> This appraisal is made for the purpose of determining the sound, physical value of the herein described property. Economic factors that would affect the market value of this property have not been considered. This report, in no way, is to be construed as determining Market Value, Liquidation Value, Loan Value, or any other type of value that would necessitate the consideration of economic factors.
>
> * * * * *
>
> All items of construction and equipment have been listed in detail, and priced on the basis of local replacement cost. In the case of standard manufactured articles, the manufacturer's price, plus freight and cartage has been used.

The twelfth report based its appraisals on the fair market value of lands, buildings, other improvements, and equipment of San Joaquin Packing and Kerman Tallow.

Keith assisted in the preparation of the appraisals by making a survey of the existing plant facilities. As a result, he had a detailed knowledge of the production facilities at the various plants and, in addition to assisting in the negotiations for the partnership assets,

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[3]Land and equipment not appraised by Tait, either because it was not in existence at the time the appraisals were made or because it was somewhat specialized as to use or location, was appraised by company officers.

he supplied the Tait Appraisal Company some of the information used by it in preparing its appraisals. The appraisals were examined and relied upon by the keymen and the Jerome brothers in their negotiations concerning the price to be paid for the partnership business. Three of the keymen, Nelson, Andreoli, and Frederick, all of whom had accounting backgrounds and who were familiar with the appraised assets, analyzed the appraisals and discussed their conclusions relating to the valuation of the assets with the other keymen, as well as with the Jerome brothers, in placing a dollar value on the partnership business to be acquired by the 10 individuals. The 1961 negotiations resulted in all 10 individuals agreeing to a purchase price of $3,212,000 for the partnership assets in question. Nelson discussed with the other keymen the various considerations that went into determining that price and indicated that in his judgment $3,212,000 was a fair price. This price was based upon the fixed assets included in the Tait and General appraisals as well as other partnership assets such as cash, accounts receivable, and certain land and equipment which had been excluded from the appraisals. The purchase price also took into account the redemption price which Kerman Tallow and San Joaquin Packing had paid in March 1961 to redeem Wardlaw's interest in those corporations. In arriving at the purchase price, the Jerome brothers made no request for payment of goodwill and the keymen made no offer to pay for goodwill.

Inasmuch as the keymen were not financially able to raise sufficient moneys to pay for the partnership's tallow and rendering business, it was necessary that the purchase price be paid off out of earnings of the busi-

ness over an extended period of time. In order to better determine the ability of the business to pay the purchase price out of current earnings, Frederick, one of the keymen who was responsible for marketing, projected a market program to determine the ability of the business to make such payments. Andreoli prepared a cash flow analysis based on projected earnings anticipated from the business over a 10-year period and arrived at the conclusion, which was reviewed and concurred in by Nelson and reinforced by Frederick's marketing projection, that while the purchase price could not be paid off within a 10-year period, as the Jerome brothers had desired, it could be paid off out of current earnings in a period of 15 years. Andreoli discussed this conclusion with the Jerome brothers and based upon Andreoli's analysis, the brothers agreed to a 15-year period.

The keymen and the Jerome brothers also discussed the matter of the amount of the initial payment on the purchase price. Originally the brothers wanted $300,000, which the keymen felt was too high, but after further negotiations, the brothers agreed to accept $150,000, which was made as the first principal payment under a promissory note. In respect to the interest rate on the unpaid balance of the purchase price, the parties agreed upon a level interest rate of $80,000 per year for 15 years, which amounted to 5 percent on an annual basis. The leveling out of the interest rate was made in order that the acquiring group could make lower interest payments in the earlier years with the corresponding advantage to the brothers derived by leveling out their interest income over the 15-year pe-

riod.[4] Although the partnership's average annual net earnings in the 5 years ended June 30, 1961, was only $72,200,[5] and the annual payments required to be made by the acquiring group under the purchase agreement was $280,000 per year, the decision to accept such terms was based upon the projected growth rate of the company's sales and earnings.

In May of 1961, after the parties had agreed to the price and terms of the contemplated transaction, the parties and their accountant consulted with tax counsel for the purpose of having the contemplated transaction effectuated in the most beneficial manner from a tax point of view.

On May 14, 1956, a California corporation was organized under the name of American Extraction Company but it remained dormant until May 2, 1961, at which time it was reactivated and its name changed to Jerome Brothers.[6] On June 20, 1961, an application was filed by the Jerome Brothers corporation for a permit to issue 10 percent of its stock to each of the seven keymen and each of the three Jerome brothers. On June 23, 1961, the Commissioner of Corporations of the State of California issued a permit to the Jerome Brothers corporation authorizing it to issue and sell its

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[4]Inasmuch as the acquiring group was required, under the promissory note in question, to make a total annual payment of $280,000 in each of the 15 years, any advantage in making level interest payments would appear to flow only to the Jerome brothers.

[5]Although petitioners' witnesses testified to average annual net income of between $80,000 and $90,000 during this period, petitioners' Ex. 41 revealed total net earnings during the period of only $361,000, or a yearly average of $72,200.

[6]The Jerome Brothers corporation was a legal entity separate and distinct from the Jerome Brothers partnership previously mentioned.

stock to the 10 individuals named in the application dated June 20, 1961. Shortly after the issuance of that permit, each of the 10 individuals made a capital contribution to the corporation in the amount of $500, for a total paid-in capital of $5,000, and thereby acquired 5 shares constituting 10 percent of the issued and outstanding stock of Jerome Brothers corporation. On July 25, 1961, the corporation's name was changed from Jerome Brothers to Baker Commodities, Inc. (hereinafter New Baker),[7] and each of the 10 individuals who received stock in the corporation on or about June 23, 1961, has at all times since that date been owner of record of 10 percent of the issued stock of that corporation.

On June 26, 1961, an "Agreement of Purchase and Sale" was entered into between the Jerome Brothers partnership, as seller, New Baker, as buyer, and the individual stockholders of the corporation, under which New Baker acquired from the partnership all the issued and outstanding stock of Old Baker and Phoenix Tallow and 50 percent of the issued and outstanding stock of Kerman Tallow and San Joaquin Packing, together with two parcels of real property owned by the partnership. The agreement provided for a purchase price of $3,150,000 together with an assumption of indebtedness of

[7]While the corporation which acquired the partnership's tallow and rendering business in June 1961 was technically "Jerome Brothers," future reference to the successor corporation will be to Baker Commodities, Inc., or New Baker. Since the successor corporation adopted the same name as one of the corporations formerly owned by the Jerome Brothers partnership, i.e., Baker Commodities, Inc., we have adopted the designations "New Baker" and "Old Baker" to distinguish the former from the latter.

the partnership in the amount of $62,000,[8] amounting to a total purchase price of $3,212,000. The purchase price was evidenced by the 15-year promissory note above referred to in the principal amount of $3,150,000, bearing interest at the level rate of $80,000 per year, with principal payable in equal annual installments of $200,000 over the 15-year period.

Under the terms of the agreement, each of the 10 stockholders was required, at the time of closing, to pledge 4.6 of his 5 shares, or 92 percent thereof, with a pledgeholder for the purpose of securing the payment of the promissory note. With respect to the stockholders' pledged shares, the agreement provided the following:

> LIMITATION ON STOCKHOLDERS' LIABILITY
>
> Anything to the contrary herein contained notwithstanding, Stockholders shall have no personal liability to pay the aforementioned promissory note except from the proceeds resulting from the sale of the aforementioned pledged shares, and in no event shall the Stockholders be personally liable for any deficiency arising from the sale of such shares, nor shall any action or proceeding be brought by the Seller against the Stockholders to recover a personal judgment against the Stockholders, or any of them, upon the aforementioned promissory note.

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[8]The unpaid balance due on a first deed of trust securing certain California property was in the amount of $50,000, and the unpaid balance due on a first mortgage securing certain Arizona property was in the amount of $12,000, together constituting a total assumption by the corporation of $62,000.

In addition, the agreement imposed the following restrictions on the corporation so long as any part of the promissory note remained unpaid:

"COVENANTS OF BUYER

* * * Buyer will not, without prior written consent of Seller:

A. Make any change in the compensation, direct or indirect, to any officers or Stockholders of Buyer;

B. Permit any form of distribution of its corporate assets including, but without limitation thereto, the payment of dividends in stock or in cash;

C. Make any sale, assignment, conveyance, mortgage, pledge, encumbrance or lien of any of its assets, or any part thereof, except in the usual and ordinary course of business;

D. Amend its Articles of Incorporation or issue any additional shares of stock of any class;

E. Create any new debt of Buyer in excess of $500,000.00 except in the usual and ordinary course of business in connection with purchase money obligations and obligations under conditional sales contracts or other title retention agreements with respect to new equipment acquired by the Buyer for use in the ordinary and usual conduct of its business;

F. Make loans, advances or guarantees to any person, firm or corporation except by way of assumption of liabilities of any subsidiary of the Buyer in connection with the liquidation and dis-

solution thereof and except that the buyer may make loans or advances not exceeding at any time the aggregate amount of $100,000.00 of which amount not more than $25,000.00 in the aggregate shall constitute loans or advances to officers or employees of the Buyer;

G. Purchase or acquire stock or securities or assets or the business of any other person, firm or corporation except: (1) by liquidation and dissolution of a subsidiary; or (2) all or a portion of the assets and business of any person, firm or corporation engaged in a business similar to that of the Buyer provided that the purchase price paid for any such transaction of purchase or acquisition shall not exceed $250,000.00;

H. Enter into any partnership arrangement;

I. Merge or consolidate with any other corporation.

The Buyer further covenants that Buyer will at all times carry multiple risk insurance and maintain public liability and property damage insurance satisfactory to the Seller and that it will maintain its corporate existence and all licenses and franchises necessary or desirable to the profitable conduct of Buyer's business.

A pledge agreement executed by the 10 individual stockholders of New Baker and incorporated by reference into the agreement of purchase and sale provided that although the pledged stock was to be transferred to a pledgeholder, the pledgors (stockholders) would retain their voting rights in New Baker. Under the

pledge agreement the pledgors obligated themselves as follows:

COVENANTS OF PLEDGORS

> The Pledgors [seven keymen and three Jerome brothers, by definition] covenant that while this Agreement is in full force that they will cause the Buyer [New Baker] to perform all the terms, covenants and agreements of the Agreement of Purchase and Sale between Pledgee [Jerome Brothers partnership] and Buyer executed on the date hereof and will cause Buyer to make full and timely payment of the promissory note issued by Buyer to Pledgee in accordance with said Agreement of Purchase and Sale.

In the event of default by the pledgors, the pledge agreement provided as follows:

DEFAULT

> Pledgeholder shall, upon notice by Pledgee in writing that Pledgors are in default in the performance of any of the terms, covenants and agreements of this Agreement on their part to be kept and performed and such default continues for thirty (30) days, sell the pledged shares, or any part thereof, at public or private sale on fifteen (15) days notice, in writing, to Pledgors of the time and place of such sale. Pledgors shall apply the proceeds of such sale to the payment of the expenses incident thereto, including counsel fees, and to the payment of the principal and interest upon the promissory note. Surplus, if any, shall be paid to the Pledgors in proportion to heir interest in the shares of Buyer. At any sale of the pledged shares

deposited hereunder, Pledgee may purchase the whole, or any part, of the pledged shares sold and receive title thereto free from any claim or demand of Pledgors.

There has been no default under the purchase and sale agreement and as of the time of trial, it was in full force and effect.

The promissory note referred to in the agreement of purchase and sale was executed on June 26, 1961, and provided as follows:

PROMISSORY NOTE

$3,150,000.00 Los Angeles, California June 26, 1961.

In installments as herein stated, for value received, we promise to pay to JEROME BROTHERS, a co-partnership, or order, at Los Angeles, California, the sum of THREE MILLION ONE HUNDRED FIFTY THOUSAND DOLLARS ($3,150,000.00) with interest as herein stated.

Principal payment of ONE HUNDRED FIFTY THOUSAND DOLLARS ($150,000.00) shall be paid on June 30, 1961, and principal payments shall be payable annually thereafter in equal annual installments in the amount of TWO HUNDRED THOUSAND DOLLARS ($200,000.00) commencing on June 30, 1962, and continuing thereafter annually until said principal has been paid in full.

Interest on this obligation shall be payable and accruable at a level rate of FORTY THOUSAND DOLLARS ($40,000.00) semiannually for thirty

(30) consecutive semiannual payments, the first of which shall be payable on or before December 31, 1961, and the others each successive six (6) months thereafter, payable on or before June 30 and December 31 of each year until a total of thirty (30) such semiannual installments of interest shall have been paid. Should any principal installment not be paid on or before the due date thereof as hereinabove provided, an additional interest charge shall be payable by maker at the rate of five per cent (5%) per annum on the amount of such principal payment not paid when due until the same shall have been so paid and such additional interest shall be payable on demand. Should interest installments not be paid at the times specified herein each shall bear interest thereafter at the rate of five per cent (5%) per annum payable on demand.

Should default be made in payment of any installment of principal or interest when due, the whole sum of principal and interest shall become immediately due at the option of the holder of this note.

If the maker shall become insolvent or if it should make a general assignment for the benefit of creditors or if it should file a petition in voluntary bankruptcy or if an involuntary petition in bankruptcy be filed against it and not be dismissed within thirty (30) days from the filing thereof or if a receiver be appointed for the property or assets of maker and such receivership not be discharged within thirty (30) days from the appointment of said receiver, then and in any such event this note

shall at the option of the holder become entirely due and payable immediately.

This note is subject to a certain "Agreement of Purchase and Sale" dated June 26, 1961, * * * and is further subject to a certain "Pledge Agreement" dated June 26, 1961, * * *

If action be instituted on this note, then the maker shall pay such sum as the Court may fix attorneys' fees.

Also on June 26, 1961, New Baker and its stockholders entered into an agreement of purchase and sale with the Wilson Company pursuant to which New Baker purchased from that company the remaining issued and outstanding shares of corporate stock of Kerman Tallow and San Joaquin Packing. The agreement provided for a total purchase price of $250,500, to be evidenced by a promissory note in that amount with interest at the rate of 6 percent per annum on the unpaid balance. Principal and interest were payable in 30 semiannual installments of $12,725.40 each. In all other respects this contract contained the same terms, provisions, and conditions as the agreement entered into on the same day between the Jerome Brothers partnership and New Baker, including a pledge agreement entered into by the 10 New Baker stockholders in favor of the Wilson Company.[9] Robert S. Wilson, sole owner of the Wilson Company, was aware that the price, terms,

[9]The pledge agreement in favor of the Wilson Company provided that the stockholders as a group would deposit 4 shares of New Baker stock with the pledgeholder. Since 46 of the 50 issued and outstanding shares of New Baker stock were already pledged, the pledging of the remaining 4 shares, or 4-10ths of a share by each of the 10 shareholders, left no New Baker stock unpledged as of June 26, 1961.

and conditions surrounding the sale to New Baker of his company's 50 percent interest in Kerman Tallow and San Joaquin Packing were identical to those surrounding the sale by the Jerome Brothers partnership to New Baker of the other 50 percent interest in Kerman Tallow and San Joaquin Packing.

By reason of the purchase of all the issued and outstanding stock of Old Baker, Phoenix Tallow, Kerman Tallow, and San Joaquin Packing, those corporations became wholly owned subsidiaries of New Baker. At all times after June 26, 1961, San Joaquin Packing and Phoenix Tallow continued to be operated by New Baker as wholly owned subsidiaries. However, within 5 days after June 26, 1961, New Baker adopted resolutions to liquidate Old Baker and Kerman Tallow. The minutes of the corporation's board of directors' meeting of June 26, 1961, provided, in part, as follows:

> The Chairman further stated that * * * it had been decided that it would be in the best interests of * * * [New Baker] that a plan of complete liquidation be adopted by * * * [New Baker] as the sole shareholder of * * * [Old Baker and Kerman Tallow] whereby * * * [Old Be liquidated and all of their assets distributed to * * * [New Baker] in complete cancellation of all of the shares of * * * [Old Baker and Kerman Tallow] all in accordance with Section 332 of the 1954 Internal Revenue Code. A discussion ensued first as to the advisability of liquidating * * * [Old Baker] in accordance with the aforementioned plan.

Thereupon, on motion duly made, seconded and unanimously carried, it was

> RESOLVED, that this corporation, as the sole shareholder of * * * [Old Baker] a California corporation. ("the subsidiary"), hereby adopts a plan of complete liquidation of the subsidiary whereby all of the assets of the subsidiary be distributed to this corporation in liquidation and in complete cancellation of all of the shares of the subsidiary and that this corporation does hereby consent to the winding up of the affairs of * * * [Old Baker] and to its voluntary dissolution;
>
> * * * * * * *

The minutes of that meeting indicate that a similar discussion ensued as to the advisability of liquidating Kerman Tallow. As with Old Baker, the board resolved to completely liquidate and dissolve Kerman Tallow.

Shortly after the liquidation of Old Baker and Kerman Tallow, New Baker's internal auditing staff and its outside accounting staff allocated the purchase price of the stock in those companies to the various tangible assets acquired by New Baker as the basis thereof. These allocations were based principally upon the Tait and General appraisals. Within 3 months after the allocations were made, the corporation sold several items of equipment at a price which was $108,228.57 less than their recently allocated basis.

Each of the stockholders of New Baker, with the exception of Keith, has at all times from June 26, 1961, to the time of trial been an employee of New Baker. At the time of trial Shultz was a vice president and

general manager of New Baker; Frederick was employed as its vice president in charge of sales; Andreoli was employed as its treasurer, controller, and office manager; Sanderson was plant superintendent; Nelson was secretary; Rickret was vice president in charge of customer relations; Varney Jerome was employed as general manager of Phoenix Tallow and was an employee of New Baker; Paul Jerome was employed by New Baker as a general manager of its Albuquerque operations; and Frank Jerome was employed by New Baker as its president.

The following is a comparison of the net sales and earnings of the Jerome Brothers partnership from 1957 to 1961 and of its successor, New Baker, from 1962 to 1965:

Fiscal year ended June 30	Net Sales	Net earnings[1]
1957	$ 8,041,000	$ 71,800
1958	9,345,000	19,500
1959	11,842,000	124,300
1960	10,981,000	85,500
1961	12,080,000	59,900
1962	17,970,000	68,800
1963	27,105,000	129,400
1964	36,465,000	481,600
1965	48,899,000	44,500

[1]After deductions for depreciation, interest on notes, and income taxes. New Baker's income tax returns for its fiscal years ended June 30, 1962 and 1963 reflected depreciation deductions of $586,609.68 and $408,286, respectively.

The average annual net earnings for the 5-year period ended June 30, 1961, was $72,200, and the average annual net earnings for the 4 years ended June 30, 1965, was $181,075.

Prior to the time the keymen acquired ownership interests in New Baker, Frank Jerome had been advised by his attorney that if the keymen were each given a 10 percent interest in New Baker, the three Jerome brothers would lose control of the business inasmuch as they would own only 30 percent of the company's voting stock. After New Baker acquired the tallow and rendering business owned by the Jerome Brothers partnership, a shift occurred in management responsibilities and authority to the extent that the keymen, principally Andreoli, assumed more responsibility and more administrative control over the operations of New Baker. Prior to May of 1961, contact between the Jerome Brothers partnership and its attorneys was conducted almost exclusively by Frank Jerome insofar as the decision-making process was concerned. Beginning in May of 1961, however, New Baker's attorneys had occasion to work with each of the stockholders on legal problems (other than Rickert who was located permanently in Kerman, California), and subsequent to June of 1961, New Baker's attorneys' contacts with the corporation in the area of decision-making have been mainly with the keymen. In the area of banking, the bank which served the needs of the partnership and later New Baker has dealt more frequently with the keymen than with Frank Jerome since June of 1961.

At the time New Baker acquired the tallow business from the Jerome Brothers partnership, there existed obligations owing from the partnership to the Bank of America (hereinafter the bank). Inasmuch as New Baker was to assume these partnership obligations, the bank, in order to protect itself, required the three Jerome brothers to subordinate the New Baker promissory note

to the bank loan and, in addition, to personally guarantee New Baker's indebtedness to the bank. Inasmuch as the bank viewed the three Jerome brothers as the principal creditors of New Baker, the bank would not have advanced credit to New Baker without the subordination agreement and their personal guarantee.[10]

At no time after New Baker acquired the partnership assets was there an agreement, oral or written, or any understanding of a tacit nature between the Jerome brothers and the seven keymen restricting the latter's rights to vote their New Baker stock or in any way transferring to Frank, Paul, or Varney Jerome voting control of New Baker. Neither has there existed any voting trust agreement relative to the stock of New Baker. Since June of 1961, all 10 stockholders of New Baker have served on its board of directors and have attended and voted at the board meetings. While the three Jerome brothers attended these meetings from time to time, Frank was absent most of the time.

In 1958 Keith started experimental engineering work to design a continuous operation plant for the purpose of converting Old Baker's batch-cooking process to a continuous cooking process. The continuous process had the advantage over the batch process of greater output, less labor, higher quality of end product, and less loss where volume production was involved. When New Baker acquired the partnership tallow business in June 1961, the continuous cooking process was still in an experimental state and was not sufficiently perfected for

[10]In the opinion of the vice president and manager of the bank handling the loan account of both the Jerome Brothers partnership and later New Baker, at the time of its incorporation New Baker was "thinly capitalized" and had a "very nominal" net worth.

commercial purposes until about mid-1962, at which time some of New Baker's Los Angeles operations converted from a batch-cooking process to a continuous process.[11] Although some of the equipment used in New Baker's batch plants was sold, the bulk of that equipment was transferred to other New Baker plants which did not produce sufficient volume to justify a continuous process plant but were in need of better batch-cooking equipment than they possessed.

The operations of the Phoenix plant relocated and converted to a continuous process plant about October 1964. This relocation was made pursuant to plans adopted 9 months to a year prior to that time.[12] The Phoenix batch plant continued to be used until approximately May of 1965 inasmuch as the new continuous plant was not able to be fully used until that time.

Respondent's sole witnessd a cost estimator, was of the opinion that the assets purchased by New Baker from the Jerome Brothers partnership in 1961 had a total fair market value of $3,069,782.27,[13] of which he attrributed $600,000 to going concern value, including goodwill, leaving an estimated fair market value of $2,469,782.27 attributable to fixed assets. In arriving at his cost estimate, the witness did not personally inspect the buildings and equipment which were located

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[11]Keith and Andreoli testified that as of the June 1961 partnership acquisition they were not aware of any plan to dismantle the Los Angeles batch plant. Dismantling of the plant, which began in mid-1962 was completed by approximately February of 1966.

[12]As of June 1961, Keith had no knowledge of any plans to relocate the Phoenix plant.

[13]This figure was less than $150,000 (or approximately 4% percent) lower than the negotiated price of $3,212,000 which had been paid for the partnership assets by New Baker.

in Albuquerque, New Mexico, Honolulu, Hawaii, Omaha, Nebraska, and Kerman, California. Neither was he personally familiar with New Baker's land holdings in Kerman, California, New Mexico, Hawaii, and Nebraska. In appraising the properties which he had not personally inspected, the witness relied primarily on the description of those properties as supplied by the Tait and General appraisals. In making his cost estimate, he assumed that all equipment, including that which he had not actually inspected, was in good working order. The only properties which the witness personally inspected were those located in Los Angeles and Phoenix. While inspecting the Los Angeles plant, the witness examined only a minor portion of the equipment included in the Tait appraisals. As to the equip- he made no attempt to tie it into the Tait appraisals, except for one blood plant cooker. In Phoenix, the witness saw a majority of the equipment which had been included in the Tait appraisals. At the time respondent's witness appraised New Baker's business in early 1966, he had no familiarity with the tallow business in general and had never appraised a tallow company. The witness viewed New Baker as a brokerage-type business and concluded that since a brokerage business is a service business and since most service businesses contain an element of good will, New Baker likewise had goodwill. In coming to this conclusion, the witness made no effort to determine whether or not New Baker had competitors, what markets it served, or what percentage of the company's products was sold outside the United States.

Manchester Medical Hospital, a limited partnership (sometimes hereinafter called Manchester), was created

on or about January 1, 1958, for the sole purpose of constructing, owning, and operating a convalescent hospital. Immediately prior to March 1, 1961, the general and limited partners of Manchester, and their respective percentage interests were as follows:

General partners		Limited partners	
James F. Peacock	33.33	Frederick	4.17
Frank Jerome	11.11	Sanderson	4.17
Paul Jerome	11.11	Andreoli	4.17
Varney Jerome	11.11	Shultz	4.17
		Nelson	4.17
		Norman Macbeth	4.17
		H. E. Akin and W. R. Poulton	4.17
		William Ross	0.166
		Richard Gunter	0.166
		Dean Scofield	0.83

Manchester was at all times a completely separate and independent entity whose business of operating a convalescent hospital was in no way connected with that of any other business involved in this proceeding. Pursuant to the purpose for which Manchester was formed, a convalescent hospital was in fact built and operated by it. The partnership ran into severe financial difficulties and the hospital was closed about July 1960. On March 1, 1961, the partnership, by installment sale, conveyed all of its assets to Southwest Community Hospital Association (hereinafter Southwest), a nonprofit corporation which was unrelated to any of Manchester's partners or any of the parties or entities involved in this case. Southwest gave a promissory note for the purchase price, secured by a chattel mortgage and deed of trust on the hospital property, each of which documents was dated March 1, 1961. The sale was also evidenced by a written agreement of sale, grant deed, and bill of sale, each of which was also dated March 1,

1961. Southwest commenced operating the hospital for its own account on or about March 1, 1961, and after that date Manchester no longer engaged in active business. In order to report income received from the 1961 installment sale, a partnership tax return was prepared and filed for Manchester for 1961 and 1962. Manchester filed its final tax return for the fiscal year ended August 31, 1962, reporting collections on installment sales in the amount of $36,623.97. While no other receipts or gross income was reflected on that return, it did reflect an unpaid balance of $12,500 on Southwest's note.

American Extraction Company, a limited partnership (hereinafter American)[14] was created on or about September 1, 1956, for the sole purpose of purchasing sewer skimmings from various governmental sewage disposal plants in order to extract and market grease contained in such sewer skimmings. As of 1960 and until its termination, the general and limited partners of American and their respective percentage interests were as follows:

General partners		Limited partners	
Frank Jerome	22.33	Keith	3.00
Paul Jerome	22.33	Shultz	3.00
Varney Jerome	22.33	Sanderson	3.00
		Frederick	3.00
		Nelson	3.00
		Andreoli	3.00
		John H. Haugh	3.00
		Robert S. Wilson	3.00
		Edwarde Ricci	3.00
		James F. Peacock	3.00
		Frank Jerome	1.00
		Paul Jerome	1.00
		Varney Jerome	1.00

[14]This partnership, while similar in name, is to be distinguished from the California corporation which has been previously identified and whose name was changed in 1961 to Jerome Brothers.

In September of 1956, pursuant to the purpose of such limited partnership, American entered into a written agreement with the County of Los Angeles and began purchasing sewer skimmings from it. In late 1958, American entered into an agreement with the County of Orange, California, and began purchasing sewer skimmings from that county in addition to those being purchased from Los Angeles County. A third agreement was negotiated in April 1959 with the City of Los Angeles and American began purchasing sewer skimmings from it about October 1, 1959. No other contracts were obtained by American. By the end of July 1960, all three agreements were terminated by American and it thereafter terminated all operations because the grease obtained from the sewer skimmings could not be sufficiently purified to make it marketable in profitable quantities.

At the time American terminated operations in 1960, it possessed approximately 3 million pounds of skimmings which were turned over to Old Baker for sale under an oral agreement whereby Old Baker was to pay for it if and when sold. The skimmings were stored in Old Baker's storage tank on Pier D, Berth 30, Long Beach, California. In April or May of 1961, Old Baker determined that there might be a possibility of a market for the skimmings and sometime after receiving the results of a laboratory test on the fatty acid content of the skimmings, dated June 15, 1961, New Baker's[15] vice president in charge of sales, Frederick, authorized the company to purchase the skimmings from American

[15]After New Baker acquired the Jerome Brothers partnership on June 26, 1961, New Baker apparently acquired the same contractual rights to the skimmings as were possessed by Old Baker prior to that date.

at a price of 3 cents per pound. American received final payment from New Baker sometime subsequent to Frederick's authorization.

The last partnership income tax return for American was filed for the calendar year 1960. Those individuals who had been partners in American reported income received from the 1961 disposition of American's inventory on their individual income tax returns for that year. When in early 1962 it was discovered that no formal steps had been taken to dissolve American, Nelson, New Baker's accountant and auditor, notified New Baker's legal counsel of that fact and requested that they prepare a formal certificate of cancellation of the limited partnership as of June 30, 1961, the end of old Baker's fiscal year. Such a certificate was prepared, and on January 10, 1962, it was recorded.

A Panamanian corporation known as Veronica Compania Naviera S.A. (hereinafter called Veronica) was organized by the three Jerome brothers on or about August 15, 1956. The purpose of the corporation was to engage in the chartering and operation of ocean-going vessels. As of December 1962, all of the issued and outstanding capital stock of that corporation was owned by Frank, Paul, and Varney Jerome in equal amounts. The company had been actively engaged in business at all times since its organization. In 1962, the officers of New Baker discussed with the Jerome brothers the possibility of acquiring their Veronica stock. After being advised by their attorney that the Revenue Act of 1962 would cause adverse tax consequences to United States citizens owning stock in foreign corporations, the brothers indicated a willingness to sell their Veronica stock.

In December 1962, a stockholders' meeting was held at which a full discussion took place between the various stockholders of New Baker concerning the advisability of purchasing the Veronica stock. Specifically discussed was a written marketing agreement which existed between Veronica and the Legaspi Oil Company (hereinafter Legaspi), a Philippine corporation, pursuant to which Veronica was entitled to the exclusive right to market Legaspi's products, principally coconut oil. The New Baker shareholders considered the marketing agreement thoroughly in order to project potential income which New Baker might derive from it and thereby determine the price that New Baker should pay for the Veronica stock. The marketing agreement had approximately 7 years to run and based upon a projection made by Andreoli of the estimated income that could be derived from the agreement and as to what it would cost New Baker to broker the material, it was determined by the keymen that the contract could produce a good income over its remaining life. The marketing agreement provided for a 1 percent brokerage fee which was unique in that New Baker would be able to obtain a 1 percent fee for handling commodities for Legaspi although New Baker would not have to pay the 1 percent brokerage fee when it marketed the commodities itself. In effect, New Baker could either sell the commodities direct or sell the commodities to other brokers whose commission fee was then less than 1 percent.[16] Based upon this comparative advantage over

[16]The testimony of petitioner's vice president in charge of sales, Frederick, emphasized the economic advantage to New Baker under such an agreement. Based upon a "current cost" of 15 cents a pound for coconut oil, or $300 a ton, a 1 percent brokerage fee amounts to $3 a ton which New Baker would re-

other brokers in the industry, Andreoli was able to place a value of $350,000 on the marketing agreement in December 1962.[17]

The net assets of Veronica in December 1962 (other than the marketing agreement) consisted of contracts and notes receivable in the amount of $964,599.13. At the time New Baker was negotiating the purchase of Veronica's stock, since it did not know whether it would be able to collect all of the receivables on the books of Veronica, the parties agreed to an offset for uncollectible accounts in the amount of $214,599.13 resulting in a purchase price of $1,100,000.[18]

By an "Agreement for the Sale of Stock" dated December 20, 1962, New Baker acquired all of the issued and outstanding stock of Veronica from the Jerome

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ceive for acting as broker of Legaspi's production whereas the normal brokerage fee in the industry was only $1 a ton. Additionally, Legaspi's production increased from 6,000 to 9,000 tons a month from December 1962 to the time of trial, causing New Baker to realize a 50 percent increase in income from the marketing agreement.

[17]The estimated value of marketing Legaspi's products was placed at $1,113,000 per month, which was expected to produce approximately $11,130 in brokerage income. Since New Baker estimated that its monthly selling cost was $5,130, it was left with a gross profit of $6,000 per month, or $72,000 per year. It was decided to give the latter amount a present value of $50,000 per year or $350,000 for the estimated remaining 7-year life of the agreement.

[18]The value of Veronica's stock was computed as follows:

Assets less liabilities	$ 964,599.13
Estimated value of exclusive marketing agreement	350,000.00
Total	1,314,599.13
Less reserve for uncollectible accounts	214,599.13
Value of stock	1,100,000.00

brothers. Introductory paragraph C of the agreement provided, in part, as follows:

> C. Amongst said assets is a written agreement dated August 1, 1958, between Veronica and THE LEGASPI OIL CO, INC. ("Legaspi"), a corporation organized and existing under the laws of the Republic of the Philippines, which agreement provides in part for exclusive marketing privileges in favor of Veronica of all coconut oil and coconut products produced by Legaspi, which marketing portion of said agreement is hereinafter referred to as the "Exclusive Marketing Agreement". The Exclusive Marketing Agreement is of substantial potential future value to Buyer, fitting into Buyer's projected pattern of engaging directly or through agents in the business of buying and selling commodities on a worldwide basis. * * *

Paragraph E-IV of the agreement further provided that:

> It is agreed between the parties that of the Purchase Price $350,000.00 is the present fair value of the Exclusive Marketing Agreement and $750,000.00 is the present fair discounted value ("Net Asset Value") of the other assets of Veronica less its liabilities. * * *

In accordance with the terms of the agreement, promissory notes were executed by New Baker to each of the Jerome brothers in the amount of $366,666.67, representing one-third of the purchase price of the Veronica stock. The notes provided that no interest was payable if payments were made when due, otherwise at 6 percent from such due date.

On December 21, 1962, the board of directors of Veronica adopted a plan of complete liquidation. The following day, New Baker, the sole shareholder of Veronica, ratified the liquidation plan adopted by Veronica's board of directors. Pursuant to such plan Veronica was liquidated under the laws of the Republic of Panama on December 31, 1962, and all its assets and liabilities, including the marketing agreement with Legaspi Oil Company, were transferred to New Baker. The agreed purchase price of the stock, $1,100,000, was allocated to the assets of Veronica in accordance with the agreement of December 20, 1962, resulting in allocation of $350,000 to the marketing agreement. For the fiscal year ended June 30, 1963, New Baker deducted $25,800 as amortization of the marketing agreement.

Upon acquisition of the marketing agreement the terms of such agreement were carried out, specifically the payment by Legaspi to New Baker of the 1 percent commission. In the first 3 years under the agreement (1963, 1964, and 1965) New Baker received a gross profit from brokerage commissions of $471,000, thereby exceeding the total estimated gross profit for those 3 years by a substantial amount.[19] As of the time of trial, Legaspi had recently installed additional equipment which would increase its production capacity by 50 percent and thereby further increase the profits New Baker would derive from the marketing agreement. As a result, New Baker has received an estimated new income of $30,000 to $50,000 a year over and above all

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[19]Petitioners had estimated a gross profit of $72,000 per year or $216,000 for a 3-year period. Thus, the actual gross profit for 1963 through 1965 exceeded that estimate by $255,000 or 118 percent.

expenses, including amortization expenses. All principal payments due and owing from New Baker to the Jerome brothers on the Veronica notes have been timely paid by New Baker.

Pursuant to the terms of the promissory note given the Jerome Brothers partnership by New Baker in consideration of the property transferred to it in June 1961, New Baker made principal and interest payments to the partnership out of current earnings for the years and in the amounts following:

Year	Principal	Interest
1961	$150,000	$40,000
1962	200,000	80,000
1963	200,000	80,000

In their individual income tax returns for the calendar years 1961 through 1963, Frank, Paul, and Varney Jerome each reported as long-term capital gain the gain attributable to their distributive share of the principal payments received by the partnership from New Baker. Each partner's allocable share of the interest payment was reported as ordinary income and New Baker, on its corporate tax returns filed for the fiscal years ended June 30, 1962 and 1963, correspondingly, claimed as an expense, the interest payments made to the partnership under the note.

In 1961, as a result of New Baker liquidating two of its wholly owned subsidiaries, Kerman Tallow and Old Baker, New Baker used a stepped-up basis on the assets thus received in computing subsequent deductions for deprectiation, cost of goods sold, and losses on the sale of assets. In the following year, as a result of New Baker liquidating Veronica, another wholly owned

subsidiary, New Baker similarly used a stepped-up basis in allocating the amount it had paid for the Veronica stock to the various assets received from Veronica, including the exclusive marketing agreement.

In the notices of deficiency received by New Baker dated December 14, 1964, respondent disallowed those interest deductions claimed by New Baker as paid on the promissory note given the Jerome Brothers partnership in 1961. In addition, respondent determined that New Baker was not entitled to a stepped-up basis on any of the assets received from the liquidation of Old Baker Kerman Tallow, or Veronica, thereby disallowing New Baker's claimed loss deductions as well as part of the deductions claimed for depreciation and cost of goods sold.

In the notices of deficiency received by the individual petitioners dated June 17, 1965, respondent determined that all amounts of income received by the Jerome Brothers partnership from New Baker constituted qualifying dividends, taxable as ordinary income to the individual petitioners rather than as interest income and long-term capital gain income, as reported by them on their returns for 1961 through 1963.

OPINION

Issue I

Upon acquiring the stock and real estate from the Jerome Brothers partnership in 1961, New Baker gave the partnership a promissory note which required New Baker to make interest payments at the annual rate of $80,000. Pursuant to that requirement, New Baker made the payments and claimed the amount so

paid as an interest deduction on its corporate tax return for each of the fiscal years ended June 30, 1962 and 1963. Respondent disallowed the interest deductions on the ground that the claimed amounts did not arise out of a bona fide indebtedness but rather constituted non-deductible corporate dividends. Respondent's disallowance was predicated upon the theory that the promissory note actually represented a risk capital investment by the partners in the nature of preferred stock, and therefore, the $80,000 annual payment made by New Baker to the "stockholders" constituted dividends. In determining whether the promissory note evidenced a true debtor-creditor relationship, as petitioners contend, or only a risk capital investment as respondent contends, we are required to examine all pertinent facts in the record, there being no single test for determining whether an obligation which appears on its face to be a true evidence of indebtedness is such in fact. *Charles E. Curry,* 43 T.C. 667 (1965).

If form alone were controlling, we think the note in question clearly evidenced a true indebtedness. It contains an unconditional promise to pay a sum certain, together with interest, at designated intervals. The noteholder has the right to declare the entire balance due if the maker defaults in the payment of any installment of principal or interest and if the noteholder is required to institute action in order to collect on the note, he is entitled to reimbursement from the maker for attorney fees. While form alone may be relevant and entitled to some weight, *Charles E. Curry, supra,* we are required to examine all the relevant factors in order to determine whether the substance of the transaction complies with its form, *Gregory v. Helvering,* 293 U.S. 465

(1935). In attempting to discover whether a true debtor-creditor relationship arose upon the receipt of the promissory note in question, it is necessary to recognize the basic difference between a "stockholder" and a "creditor." As we observed in *Emanuel N. (Manny) Kolkey*, 27 T.C. 37, 58 (1956), affd. 254 F.2d 51 (C.A. 7, 1958):

> *The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit.* The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them. * * * [Emphasis in original.]

After recognizing in *Kolkey* that the decided cases had not established a comprehensive rule of thumb by which to judge the true nature of advances made to a new enterprise, we there stated the following relevant criteria for making such a determination:

> Was the capital and credit structure of the new corporation realistic? What was the business purpose, if any, of organizing the new corporation? Were the noteholders the actual promoters and enterpreneurs of the new adventure? Did the noteholders bear the principal risks of loss attendant upon the adventure? Were payments of "principal and interest" on the notes subordinated to dividends and to the claims of creditors? Did the noteholders have substantial control over the business operations; and if so, was such control reserved to them as an integral part of the plan under which

> the notes were issued? Was the "price" of the properties, for which the notes were issued, disproportionate to the fair market value of such properties? Did the noteholders, when default of the notes occurred, attempt to enforce the obligations? [27 T.C. 59.]

Turning first to the capital and credit structure of New Baker as it existed in June 1961, respondent places strong emphasis on the gross disparity between New Baker's initial capital contribution of $5,000 and its initial indebtedness of almost $3½ million.[20] We must agree with respondent that with a debt-equity ratio of almost 700 to 1, New Baker was very thinly capitalized. However, the thin capitalization factor is "only one of the indicia from which the presence or absence of a debtor-creditor relationship may be determined," *Gooding Amusement Co.*, 23 T.C. 408, 419 (1954), affd. 236 F.2d 159 (C.A. 6, 1956), certiorari denied 352 U.S. 1031 (1957), and the existence of that factor, standing alone, will not transform an otherwise valid indebtedness into equity capital. *J. I. Morgan, Inc.*, 30 T.C. 881, 891 (1958), reversed on other grounds 272 F.2d 936 (C.A. 9, 1959); *Sun Properties v. United States*, 220 F.2d 171 (C.A. 5, 1955).[21]

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[20]In addition to the indebtedness incurred by New Baker on June 26, 1961, in acquiring the partnership assets (the 15-year promissory note in the amount of $3,150,000 plus assumption of two real estate mortgages totaling $62,000), the corporation, on the same day, purchased a 50 percent interest in Kerman Tallow and San Joaquin Packing from the R. S. Wilson Co. for $250,500, evidenced by a 15-year, interest-bearing promissory note in that amount. Thus New Baker's indebtedness from these two acquisitions was $3,462,500, representing a debt to equity ratio of 692½ to 1.

[21]The point is best illustrated by the fact that the criteria recognized in the *Kolkey* case, *supra*, for determining the true

The Jerome Brothers partnership had been in the rendering business continuously since 1937. The record discloses that in the 5-year period prior to the 1961 transaction, the annual net sales of the business grew from $8 to $12 million. Although net earnings during the same period fluctuated widely, they too showed a decided upward trend. Inasmuch as six of the seven keymen were employed by the partnership in managerial and responsible administrative positions, they were in positions which made them keenly aware of the financial needs and business prospects of the company. The seventh keyman, Keith, had also gained an intimate knowledge of the business from his association as a 50 percent partner with the Jerome brothers in a manufacturing and engineering firm which was formed in 1954 and had continuously done work for the Jerome Brothers partnership, including the development of a continuous operation cooking plant for the partnership's rendering business. The continuous cooking process, which was to replace the conventional batch process, was in operation within a year after the 1961 transaction and permitted increased output and higher quality tallow at reduced costs. While the facts fail to disclose the magnitude of savings anticipated by installation of the continuous process or the degree which the keymen considered these savings in determining the size of annual principal and interest payments which the operations of the business could absorb, it is clear that Keith took an active part in the discussions leading up to the 1961 transaction and we think it a fair assumption that

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nature of advances to a new enterprise, arose in a case involving a thinly capitalized corporation. And see *Sun Properties v. United States, supra*, where it was held that a bona fide indebtedness existed in spite of a debt to equity ratio of 310 to 1.

the expectation of reduced costs resulting from installation of the continuous process was considered by the keymen in deciding on the terms of the note. In addition, and prior to agreeing to a purchase price which would require New Baker to make annual principal and interest payments totaling $280,000, Frederick, one of the keymen whose background was in business administration and accounting, set up a market program to determine the ability of the business to make payments on the Jerome Brothers partnership note out of projected future sales. Another keyman with an accounting background, Andreoli, prepared a cash flow analysis based on projected earnings over a 10-year period and arrived at the conclusion that while the purchase price could not be paid off within 10 years, as the Jerome brothers desired, it could be paid off in 15 years. Andreoli's conclusion was reviewed and concurred in by Nelson, a third keyman with a business and accounting background, and reinforced by Frederick's marketing program. The decision to use a 15-year term on the note, which was ultimately accepted by the Jerome brothers, was not only initally suggested by the keymen but was based upon figures developed by them from their intimate knowledge of the business.

The financial success of the business in the 4 years subsequent to the 1961 transaction well attests to the sound business judgment exercised by the keymen in arriving at a 15-year payout period. Not only have all payments of both principal and interest on the note been timely made out of current earnings but the company's net sales have jumped from $12 million in 1961 to almost $49 million in 1965. Whereas the average annual net earnings for the 5-year period prior to the 1961

transaction were $72,200, they were $181,075 for the 4 years following the transaction, an increase of more than 150 percent.

In *Burr Oaks Corp.*, 43 T.C. 635, 647 (1965), affd. 365 F.2d 24 (C.A. 7, 1966), certiorari denied 385 U.S. 1007 (1966), we recognized that the transfer of property to a thinly capitalized corporation raises a "strong inference" that the transfer is an equity contribution where payment to the transferor depends "solely upon the success of an untried, under-capitalized business, the profits of which are uncertain." We think the opposite inference arises where, as in the instant case, the parties intended to and in fact did make principal and interest payments out of current earnings generated by the continued success of a well established business which enjoyed not only a good past earnings' record but equally good prospects for the future. *Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116, 120 (C.A. 5, 1959), affirming 30 T.C. 519 (1958). The property acquired by New Baker from the partnership was producing substantial income and the parties, based upon marketing projections, fairly believed that payments on the note could be made without impairing the capital assets of New Baker. The existence of these facts, in the light of the highly successful operations of the business subsequent to 1961, convinces us that New Baker's capital structure was not unrealistic at the time of the corporation's inception in 1961. Thus, there is no justification for inferring, on the sole ground of thin capitalization at least, that the promissory note is not what it purports to be.

We are further convinced that the note arose out of a transaction which was entered into for valid busi-

ness reasons, was at arm's length, and was not a sham transaction. The record indicates that aside from any tax-saving considerations, the Jerome brothers had been concerned, for at least several years prior to 1961, with perpetuating the partnership business after their deaths. Having no family members in the top management of the business, they determined to transfer the entire business to a group of 10 individuals composed of themselves and 7 keymen, all of whom were familiar with the operations of the partnership business and had played an active role in its success. Since the keymen had only limited capital, it was necessary for New Baker to pay for the partnership assets out of future earnings. The testimony adduced at trial reveals that the dealings between the parties were bona fide and always at arm's length. Correspondingly, we do not interpret the multitude of facts surrounding the transaction as indicating an attempt by the Jerome brothers to transfer the business while at the same time retaining control thereof. In support of this interpretation we note that subsequent to the transaction, not only were the brothers minority stockholders, but they actually assumed less responsibility in the company's management while the keymen assumed increasingly more.

In resolving the issue before us, another controlling factor is whether the partners transferred partnership assets with reasonable expectations of repayment regardless of the success of the venture or whether, on the other hand, the transfer was made at the risk of the business. In an attempt to convince us that the 1961 transfer falls into the latter category and therefore resembles a contribution of risk capital as opposed to a loan, respondent relies heavily upon the fact that

the partners subordinated their note to "creditors." We observe at the outset that the note was subordinated to only one of New Baker's creditors—the bank—not to "creditors" as respondent contends. Although the bank was a substantial creditor of New Baker, we do not feel the subordination of the note, in light of the facts existing in June 1961, prevents the note from constituting a true indebtedness. Had the Jerome brothers agreed to subordinate their note to the general creditors of New Baker a different result might obtain. Here, however, the bank had previously extended a line of credit to the business in excess of $3 million and had to adequately protect its interests. In order to preserve the availability of bank credit to New Baker, the Jerome brothers not only agreed to the required subordination but personally guaranteed New Baker's bank debt. The brothers realized the importance of their cooperation in this matter and, inasmuch as the subordination to a single creditor was agreed to for the sole purpose of assuring the continued financial health of the business, we cannot say that solely because of that subordination the note did not constitute a true evidence of indebtedness.

As indicated in the *Kolkey* case, *supra,* another factor to be considered in determining the existence of true indebtedness is whether payments of principal and interest on the note are subordinated to corporate dividends. Where such subordination occurs it indicates a treatment of the note not typical of that usually accorded a debt obligation. Here, however, no such subordination occurred. To the contrary the agreement of purchase and sale entered into between the Jerome brothers and New Baker specifically provided that so long as

any part of the promissory note remained unpaid, the corporation was prohibited from indulging in numerous specified acts which might affect the security of the note, including "the payment of dividends in stock or cash." Pursuant to the agreement, New Baker has paid no dividends subsequent to June 1961. On the other hand, and to be accorded significance, is the fact that the corporation has never defaulted on any interest or principal payment required to be made under the note.

Also pertinent to our present inquiry is the degree of control retained by the noteholders over the business operations of New Baker. Continued control of a business by a noteholder is at least some indication that the transaction was no more than the mere shuffling of papers for the purpose of creating a tax advantage. Respondent has strongly contended that the agreement of purchase and sale entered into between the Jerome Brothers partnership and New Baker so completely restricted New Baker's corporate activities that, in effect, the Jerome brothers retained full control over the business subsequent to June 1961. In spite of respondent's several arguments on this point, we do not think his conclusion is supported by the record. While it is true that the agreement of purchase and sale imposed numerous restrictions on New Baker, we think the reason for those restrictions was to protect the Jerome Brothers partnership, as a creditor of New Baker, from indiscriminate acts of management which might severely affect the corporation's ability to make timely interest and principal payments on the note. Of equal significance, however, is the fact that those restrictions are not of a nature which would permit the Jerome brothers to bind the corporation whenever and however desired.

With regard to encumbering corporate assets and creating new debt, New Baker retained complete freedom provided it acted "in the usual and ordinary course of business." Similarly, New Baker was free to acquire new businesses and make loans provided the amounts of such transactions did not exceed $250,000 and $100,000, respectively. We search the record in vain for any significant evidence which might suggest that the brothers intended to retain effective control over New Baker after the 1961 transaction. Subsequent to June 1961, the keymen assumed more responsibility and control over the affairs of New Baker's business while the brothers, especially Frank, assumed less. This managerial transition was especially noticeable with respect to the keymen's increased contracts with New Baker's banker and attorneys. The brothers had agreed to sell the partnership assets to New Baker only after they were advised by counsel that if the keymen were permitted to each acquire a 10 percent interest in the business, the brothers would lose control inasmuch as their ownership would be reduced to 30 percent. In this respect we think it significant that not only did the keymen acquire 70 percent of New Baker's stock, but their voting rights were in no way restricted by voting trust agreements or otherwise. In fact, the company enjoyed its greatest financial success in the period subsequent to June 1961, under the increasing direction and control of the keymen.

Another factor supporting debt treatment is the disproportion between stock ownership and note ownership. At the end of 15 years, the Jerome brothers will have changed their relative ownership positions significantly. Instead of each owning a one-third interest

in the business, they will each own only 10 percent. We have held that such substantial changes in ownership support the view that the note is representative of a bona fide indebtedness. *Charles E. Curry, supra.*

A final area of inquiry suggested by the *Kolkey* case is whether the price received by the noteholders was equivalent to the fair market value of the assets transferred. The record indicates that prior to negotiations for the partnership assets, appraisals were prepared by a private appraisal concern covering most of the partnership assets. While those appraisals were based upon replacement cost rather than fair market value, the keymen who relied upon the appraisals during negotiations were well aware of what the appraisals represented. Considering the accounting and business background of the keymen, their knowledge of the sales and earnings record of the business they sought to purchase, and the length of time they spent negotiating with the brothers, we are convinced that the price they agreed to pay for the partnership assets was the result of arm's length bargaining and in fact reflected a fair price for the property acquired.

In light of all the foregoing facts surrounding the issuance of the promissory note to the Jerome Brothers partnership in 1961, we are satisfied that the transfer of partnership assets to New Baker in exchange for the note was intended to, and did in fact, create a bona fide debtor-creditor relationship thereby entitling New Baker to deduct all interest payments made on the note.

Issue II

Within 5 days after New Baker acquired the assets from the Jerome Brothers partnership, consisting principally of stock in four corporations, it completely liqui-

dated.[22] two of those corporations, Old Baker and Kerman Tallow. New Baker then allocated the price it paid for the stock in those corporations to the assets received upon their liquidation and proceeded to use a stepped-up basis in computing depreciation, cost of goods sold, and loss on the subsequent sale of some of the assets acquired as a result of the liquidation.

New Baker justifies its use of a stepped-up basis on the ground that Old Baker and Kerman Tallow were liquidated pursuant to plans of liquidation which met all the requirements of sections 332 and 334 of the Code. Section 332(b) states the requirements which must be met in order that a corporate distribution shall be considered a complete liquidation. Section 334(b)(1), establishing the general basis rule in liquidation of corporate subsidiaries, provides that where property is received by the parent corporation in a distribution in complete liquidation of a subsidiary, the basis of the property in the hands of the parent shall be the same as it was in the hands of the subsidiary. However, in a line of pre-1954 cases, the leading one being *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), affd. per curiam 187 F.2d 718 (C.A. 5, 1951), certiorari denied 342 U.S. 827 (1951), the courts carved out an exception to the foregoing basis rule and held that where one corporation purchases the stock of another corporation for the sole purpose of obtaining assets of the second

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[22]Respondent contends that if New Baker is entitled to a stepped-up basis on the assets acquired upon the liquidation of Old Baker and Kerman Tallow, the basis of those assets should be reduced by an amount attributable to goodwill. However, respondent raises no issue with respect to the allocation of the total purchase price to each of the corporations New Baker acquired from the Jerome Brothers partnership, including Old Baker and Kerman Tallow.

corporation by a prompt liquidation, the purchase would be treated as a purchase of the assets themselves rather than the stock, thereby giving the acquiring corporation a basis in the assets equal to the cost of the stock, rather than the adjusted basis of the assets appearing on the books of the subsidiary. The doctrine established in the *Kimbell-Diamond* case was codified in 1954 as section 334(b)(2) and provides in substance that the parent corporation's basis for property acquired in a section 332 transaction is the cost of the stock rather than the subsidiary's basis for the assets, provided that at least 80 percent of the stock was acquired by "purchase" during a period of not more than 12 months. However, in an apparent attempt to limit the availability of the stepped-up basis to stock acquired from unrelated persons, the term "purchase" was defined by section 334(b)(3) as follows:

SEC. 334(b) Liquidation of Subsidiary.—

* * *

(3) Purchase Defined.—For purposes of paragraph (2) (B), the term "purchase" means any acquisition of stock, but only if—

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),

(B) the stock is not acquired in an exchange to which section 351 applies, and

(C) the stock is not acquired from a person the ownership of whose stock would, under section 318 (a), be attributed to the person acquiring such stock.

Respondent, in disallowing to New Baker a stepped-up basis on the assets in question, contends that New Baker did not acquire the stock of Old Baker and Kerman Tallow in a manner which would satisfy any of the three subparagraphs of section 34(b)(3) defining "purchase."[23] Secion 351(a) provides that—

> SEC. 351(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

Resolution of the question whether section 351 applies to the 1961 transaction requires, in turn, the two-fold determination of whether the stock of Old Baker and Kerman Tallow was transferred to New Baker "solely in exchange for stock or securities" and if so, whether the transferor group was in "control" of the corporation, as defined in section 368(c), "immediately after the exchange."

We have previously determined under issue I that the promissory note given the Jerome Brothers partnership by New Baker in exchange for the partnership's stock and real estate did not evidence an investment of risk capital by the partnership in the nature of preferred stock. Thus, since the note was not "stock" within the

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[23]Inasmuch as the three subparagraphs which define "purchase" under sec. 334(b)(3) are written in the conjunctive, if any of these subparagraphs are applicable to the facts herein, no consideration need be given to either of the remaining subparagraphs.

meaning of "stock or securities" as used in section 351, we must now decide whether the note constituted a security. In *Wellington Fund, Inc.*, 4 T.C. 185, 189 (1944), we discussed the meaning of "securities" as follows:

> The question of the meaning of the term "securities," as used in various revenue statutes, has been considered by the courts in a number of cases. The rule appears to be settled that, where such an act does not define the term [as is the case with section 351], it denotes an obligation of a character giving the creditor some assured participation in the business of the debtor, or, in other words, an investment in the business, and that the term does not include evidences of indebtedness for short term loans representing temporary advances for current corporate needs. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462; *Cortland Specialty Co. v. Commissioner*, 60 Fed. (2d) 937; certiorari denied 288 U.S. 599; *L. & E. Stirn, Inc. v. Commissioner*, 107 Fed. (2d) 390; *Commissioner v. Sisto Financial Corporation*, 139 Fed. (2d) 253.

More recently, in the case of *Camp Wolters Enterprises, Inc.*, 22 T.C. 737, 751 (1954), affd. 230 F.2d 555 (C.A. 5, 1956), we adopted the following guide for determining whether a debt instrument satisfies the meaning of "securities" as used in section 351's predecessor, section 112(b)(5) of the 1939 Code:

> Though time is an important factor, the controlling consideration is an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of

the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be the equivalent of stock since section 112(b)(5) specifically includes both "stock" and "securities."

Application of the foregoing criteria to the note in question convinces us that the note constitute a section 351 security. Whule admittedly not controlling, the fact that the term of the note is for 15 years itself strongly supports our conclusion. We have held promissory notes to be "securities" in other cases where the length of the note has been much shorter. *Daniel H. Burnham,* 33 B.T.A. 147 (1935), affd. 86 F.2d 776 (C.A. 7, 1936), certiorari denied 300 U.S. 683 (1937), 10-year note; *Camp Wolters Enterprises, Inc., supra,* 5-9-year subordinated notes. More important, however, is the fact that the note in question, together with the agreement of purchase and sale, clearly secured to the noteholder, the Jerome Brothers partnership, the continuing participation in the business which is so characteristic of a security interest. Thus, until the note was paid in full, New Baker could not, without the consent of the partnership, change the compensation of officers, declare stock or cash dividends, mortgage property except in the usual and ordinary course of business, amend the articles of incorporation, issue additional stock, create new debt or make loans above certain specified amounts, purchase stock of other businesses except within well-defined limits, enter partnership agreements, or merge with other corporations. While the intention of the Jerome brothers to continue their participation in the business was adequately secured by the foregoing restrictions, there is additional

evidence to support our conclusion. Each of the brothers obtained for himself a 10 percent interest in the new business and continued to actively participate in the management of the business not only as directors, but also as key employees and officers.[24] The foregoing facts make it clear that the noteholders secured for themsleves a significant degree of participation in New Baker's affairs before transferring their partnership assets to it. Considering all of the foregoing factors, we are compelled to hold that the promissory note in question falls within the meaning of "securities" as used in sdction 351.[25]

Having so determined, the only question remaining is whether, after the 1961 transfer of partnership assets to New Baker, the transferors were in control of the corporation as required by section 351. Control, for purposes of that section, is defined by section 368(c) as follows:

> the term "control" means the ownership of stock possessing at least 80 percent of the total com-

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[24]As of the time of trial, approximately 5 years after the 1961 transaction, Varney Jerome was general manager of Phoenix Tallow, Paul Jerome was general manager of New Baker's Albuquerque operations, and Frank Jerome was New Baker's president.

[25]Although the parties have not questioned whether the note received by the R. S. Wilson Company for transferring its 50 percent stock ownership in Kerman Tallow to New Baker constituted a sec. 351 security, we think that in deciding whether or not sec. 334(b)(2) applies, that question must be answered. Both the note given the Wilson Company for its interest in Kerman Tallow and the note given the Jerome Brothers partnership were dated June 26, 1961, were for terms of 15 years, imposed identical restrictions on New Baker until the note was paid off, and called for the periodic payment of principal and interest regardless of whether such payments could be paid out of current earnings and profits. In light of the similarities we must hold that the note received by the Wilson Company similarly constituted a sec. 351 security.

bined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Since New Baker's capital structure consists of 50 shares of issued and outstanding common stock, owned equally by 10 individuals, we must determine whether the transferor group owned at least 40 of the 50 shares after the transaction.

On or soon after June 23, 1961, each of the 10 men transferred $500 to New Baker in exchange for 10 percent of its stock. On June 26, 1961, New Baker entered into an agreement of purchase and sale pursuant to which the Jerome Brothers partnership transferred stock and real estate to New Baker in exchange for a promissory note in the amount of $3,150,000 plus New Baker's assumption of certain partnership indebtedness in the amount of $62,000, for a total purchase price of $3,212,000. Also on June 26, 1961, the Wilson Company transferred to New Baker a 50 percent stock interest in both Kerman Tallow and San Joaquin Packing in return for New Baker's note in the amount of $250,500. In determining whether the transferor group possessed the requisite control "immediately after the exchange," as required by section 351, we must decited who constituted that group, i.e., the 3 brothers, as petitioners contend, or all 10 men, plus the Wilson Company, as respondent contends. If respondent's contention is correct, the 80 percent control requirement of section 351 will obviously be satisfied inasmuch as the 10 men owned 100 percent of New Baker's stock "immediately after the exchange." The composition of the

transferor group is dependent upon whether the transfer of cash for stock by all 10 men and the subsequent transfer of corporate stock and real estate by the Jerome Brothers partnership and stock by the Wilson Company for New Baker's promissory notes are to be viewed as steps in a single transaction.

In *American Bantam Car Co.*, 11 T.C. 397, 405 (1948), affd. per curiam 177 F.2d 513 (C.A. 3, 1949), certiorari denied 339 U.S. 920 (1950), the step-transaction theory was stated as follows:

> In determining whether a series of steps are to be treated as a single indivisible transaction or should retain their separate entity, the courts use a variety of tests. * * * Among the factors considered are the intent of the parties, the time element, and the progmatic test of the ultimate result. An important test is that of mutual interdependence. Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?

Beginning with the regulations promulgaged under the Revenue Act of 1934,[26] the Commissioner has likewise addressed himself to the question and similarly concluded that—

> The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. * * *

[26]Art. 112(b)(5)-1, Regs. 86.

This definition has been continued without change in regulations under the subsequent Revenue Acts of 1936, 1938, 1939, and 1954.[27] Since it is now well settled that such a long-standing administrative interpretation applying to a substantially reenacted statute is deemed to have received congressional approval and has the effect of law, *National Lead Co. v. United States,* 252 U.S. 140, 146 (1920); *United States v. Dakota-Montana Oil Co.,* 288 U.S. 459, 466 (1933); and *Commissioner v. Noel's Estate,* 380 U.S. 678, 682 (1965), we need only decide whether the several transfers to New Baker, although not simultaneous, were made pursuant to an agreement under which "the rights of the parties * * * [had] been previously defined" and which agreement was executed "with an expedition consistent with orderly procedure."

While the record fails to disclose the existence of any written agreement which sought to specifically define the rights and duties of the transferor group, the facts amply support the conclusion that as a result of lengthy negotitions prior to June 1961 between the keymen, the brothers, and Robert S. Wilson, the sole owner of the Wilson Company, a plan to transfer the Jerome Brothers partnership assets and the Wilson Company's interest in Kerman Tallow and San Joaquin Packing to a corporation to be owned equally by the three brothers and the keymen had been carefully formulated and agreed to by all the participants. There is no suggestion in the record that any aspect of the plan was left uncertain. If this is not so, it was incumbent upon pe-

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[27]Art. 112(b)(5)-1, Regs. 94 (1936); art. 112(b)(5)-1, Regs. 101 (1938); sec. 19.112(b)(5)-1, Regs. 103 (1939); sec. 1.351-1(a)(1), Income Tax Regs.

titioners to prove the contrary, and this they have failed to do. In light of this observation as well as the fact that the execution of the agreement proceeded with orderly dispatch, we are satisfied that within the transferor group, "immediately after the exchange," there was "possessed" the requisite stock ownership in New Baker so as to bring the transaction within the language of section 351. Since New Baker acquired the stock in Old Baker and Kerman Tallow in an exchange to which section 351 applied, the stock in those subsidiaries was not acquired by "purchase" within the purview of section 334(b)(3)(B), and we must therefore hold that New Baker was not entitled to use a stepped-up basis in computing depreciation, cost of goods sold, and loss on the sale of some of the assets acquired from the liquidation of those subsidiaries.

Even if we had determined that the transaction by which New Baker acquired stock in Old Baker and Kerman Tallow constituted a sale rather than a section 351 exchange, New Baker would still not be entitled to a stepped-up basis on the assets received upon liquidation of those two subsidiaries. This follows from the fact that although section 334(b)(3)(B) would not apply, section 334(b)(3)(C) would. Petitioners concede that if Manchester Medical Hospital was in existence on June 26, 1961, and if triple attribution is permitted under the statute in question, New Baker would have acquired its stock in Old Baker and Kerman Tallow "from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock," thereby satisfying the requirement of section 334(b)-(3)(C). Since we have held in issue IV, *infra,* that Manchester was in existence as late as December 20,

1962, and also that triple attribution is required under the attribution statute in question (see issue IV), it follows that section 334(b)(3)(C) would apply so as to prevent New Baker from acquiring its stock in Old Baker and Kerman Tallow "by purchase." Thus, New Baker would not be allowed to allocate a stepped-up basis in the assets acquired upon liquidation of those two subsidiaries.

Issue III

In their individual income tax returns for the calendar years 1961 through 1963, Frank, Paul, and Varney Jerome each reported as long-term capital gain, the gain attributable to their distributive share of the principal payments received by their partnership from New Baker on the $3,150,000 promissory note. Respondent contends that the note evidenced a risk capital investment by the partnership and was therefore in the nature of preferred stock. It is therefore argued that the principal payments made on the note constituted dividends and were taxable as ordinary income to the individual petitioners. Petitioners, on the other hand, contend that the transfer of partnership assets to New Baker in 1961 constituted a bona fide sale and they are therefore entitled to long-term capital gain treatment on the principal payments. Our determination under issue I, that the note constituted a true indebtedness and was not in the nature of preferred stock, disposes of respondent's contention. Similarly, our determination under issue II, that the 1961 transaction constituted a nontaxable transfer pursuant to section 351, disposes of the authority upon which petitioners' contention rests inasmuch as it has been consistently held by this and other courts that the existence of a bona

fide sale and the application of section 351 (as well as its predecessor under the 1939 Code, section 112(b)-(5)), are mutually exclusive concepts. Cf. *Charles E. Curry,* 43 T.C. 667, at 696-697 (1956) and cases there cited.

We are of the view, however, that petitioners' contention should be sustained on other grounds. Section 1232(a)(1)[28] provides, *inter alia,* that where a corporation issues a bond, note, or other evidence of indebtedness to a person in whose hands the indebtedness constitutes a capital asset, amounts received by the holder of the indebtedness shall be considered as amounts received "in exchange therefor." Since long-term capital gain is defined by section 1222 as gain from the sale *or* exchange of a capital asset held for more than 6 months, and since the principal payments on the note were received "in exchange," it follows that petitioners are entitled to report gain from the receipt of each principal payment as long-term capital gain. *Edith K. Timken,* 6 T.C. 483 (1946), and *Howard Carleton Avery,* 13 T.C. 351 (1949).

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[28]SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) General Rule.—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) Retirement.—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

Issue IV

On December 20, 1962, New Baker acquired from the three Jerome brothers the entire stock of Veronica, a Panamanian corporation. Pursuant to a plan of complete liquidation adopted by Veronica's board of directors and ratified by its sole stockholders New Baker, Veronica was liquidated on December 31, 1962, and its assets, including an exclusive marketing agreement with Legaspi Oil Company, were transferred to New Baker. Pursuant to section 334(b)(2), New Baker allocated the purchase price of the Veronica stock to the assets acquired. Of the total purchase price of $1,100,000 for the Veronica stock, $350,000 was allocated to the marketing agreement. In its corporate tax return for the fiscal year ended June 30, 1963, New Baker claimed a deduction of $25,800 attributable to amortization of that agreement. Respondent disallowed the claimed deduction on the ground that since New Baker did not acquire the Veronica stock "by purchase," as required by section 334(b)(2), the basis provisions of that section were not available to it and New Baker's basis was therefore the same as it was on the books of Veronica, as provided by section 334(b)(1). In support of his disallowance, respondent specifically relies on section 334(b)(3)(C), which, when read in the context of section 334(b)(2), provides in substance that where a parent corporation acquires stock in a subsidiary from a person whose stock may be considered as owned by the parent under the attribution rules of section 318(a), the stock thus acquired will be deemed to have been acquired other than "by purchase," thereby precluding the parent from acquiring a step-up in basis on the assets received upon liquidation of the sub-

sidiary. Thus, the narrow issue is whether New Baker, through the attribution rules of section 318(a), constructively owned the Veronica stock at the time of its acquisition on December 20, 1962. If so, that stock was not acquired "by purchase" and New Baker was therefore not entitled to take a stepped-up basis on the marketing agreement as the result of the liquidation of Veronica.

In order that ownership in the Veronica stock be attributed to New Baker pursuant to the rules of section 318(a), both Manchester Medical Hospital and Keith Engineering must have been in existence on December 20, 1962. While petitioners do not question the existence of Keith Engineering, they contend that Manchester had ceased to exist long before December 1962. Petitioners attempt to support their contention on the ground that since the sole purpose of Manchester's existence was to own and operate a convalescent hospital, the sale of that hospital on March 1, 1961, necessarily terminated the partnership.

The facts bearing on this issue disclose that the sale of all of the assets of Manchester on March 1, 1961, was reported on the installment method. The purchaser, Southwest Community Hospital, gave Manchester a promissory note for the purchase price secured by a chattel mortgage and deed of trust on the hospital property.[29] Manchester thereafter filed tax returns for 1961

[29]In an apparent attempt to prove that the promissory note had been paid in full, petitioners' attorney testified that his law firm had prepared a satisfaction of the chattel mortgage in February 1962. Whatever weight such a document might otherwise be entitled to, we do not think petitioners are entitled to a presumption that the promissory note had been paid off inasmuch as the record fails to disclose whether or not the satisfaction of the chattel mortgage was ever executed and delivered.

as well as for the period ended August 31, 1962, for the purpose of reporting the sale and installment collections received on the promissory note. Petitioners concede on brief that the 1962 partnership return reflected an unpaid balance of $12,500 on the promissory note received by Manchester from Southwest and further, that there had been no formal dissolution of the partnership. In *J. Milton Sorem,* 40 T.C. 206 (1963), reversed on other grounds, 334 F.2d 275 (C.A. 10, 1964), we were presented with the question whether section 318(a) applied tm a partnership which, like Manchester, had ceased its business operations but continued to exist for the purpose of collecting money due the partnership. We there stated the following:

> Petitioners admit that the partnership continued to exist until April 4, 1959, for the purpose of collecting and paying accounts, but maintain that *in retrospect,* it "transacted no active business" after September 26, 1958. For this reason petitioners urge us to disregard the partnership for sec. 318 purposes, grounding their argument on the theory that the partnership attribution rules may only be *realistically* applied to a partnership which not only has legal existence but also is actively carrying on a business. We are not persuaded by this line of reasoning. The partnership *existed* immediately after the redemption; for what purpose is immaterial. As we view the statute, attribution is required by virtue of the mere *existence* of a partnership relation between corporate shareholders, and business activity has nothing to do with it. Certainly sec. 318 itself makes no reference to "business activity" as a prerequisite for partner-

> ship attribution, and in the absence of convincing authority we are unwilling to add this judicial gloss to an already complex section of the Code. [40 T.C. 214-215, fn. 14.]

Inasmuch as the partnership continued to exist, at least for the purpose of receiving the unpaid balance on the promissory note, we must reject petitioners' contention and hold that on December 20, 1962, Manchester Medical Hospital was still winding up its corporate affairs and therefore was in existence for the purpose of applying the attribution rules of section 318(a).

Petitioners contend, however, that even if Manchester and Keith Engineering were in existence, section 318(a) should not be applied in this case because to do so would require triple attribution.[30] Petitioners reason that since Congress in 1964 eliminated sidewise or double attribution with regard to partnerships, estates, trusts, and corporations,[31] it follows that the 1964 statutory amendments were merely reflective of "what Congress originally contemplated," and thus "it seems clear Congress at no time intended Section 318(a) to be construed as permitting such multiple and compound attribution as that relied upon by respondent here." However seriously we may question the philosophy of employing triple attribution in a case such as this, we must, in the final analysis, accord to the relevant provisions of section 318(a) their usual and ordinary meaning. *Malat v. Riddell,* 383 U.S. 569 (1966). After carefully considering the legislative com-

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[30]Inasmuch as the parties agree that a literal application of the relevant statutory provisions results in triple attribution, a technical explanation of that result in the context of the facts herein is unnecessary.

[31]Pub. L. 88-554 (Aug. 31, 1964).

mittee reports relating to the 1964 amendments,[32] we are convinced that those amendments were only intended to effect a change in the law subsequent to August 31, 1964, the date of their enactment. The legislative history bearing on this point in no way suggests that the purpose of amending section 318(a) might have been to clarify the meaning of that section. Congress, having become aware of the undesirable results permitted under existing law, sought to change that law. That being the case, we must reject petitioners' contention and hold that since both Manchester and Keith Engineering were in existence on December 20, 1962, for the purpose of applying section 318(a), New Baker was the constructive owner of the Veronica stock it acquired on that day and therefore it did not acquire that stock "by purchase" as required by section 334(b)(2). It follows that New Baker was not entitled to take a stepped-up basis on the marketing agreement it received upon liquidation of Veronica on December 31, 1962, and respondent's disallowance will accordingly be sustained.

Decisions will be entered under Rule 50.

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[32] S.Rept. No. 1240, 88th Cong., 2d Sess. (July 24, 1964); H.Rept. No. 1844 [Amend. 4], 88th Cong., 2d Sess. (Aug. 20, 1964).

APPENDIX C.

Internal Revenue Code of 1954 (26 U.S.C.).

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK. (Prior to 1964 Amendment*)

(a) GENERAL RULE. For purposes of those provisions of this subchapter to which the rules contained in are expressly made applicable—

* * *

(2) Partnerships, estates, trusts, and corporations.—

(A) Partnerships and estates.—Stock owned directly or indirectly, by or for a partnership or estate shall be considered as being owned proportionately by its partners or beneficiaries. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate.

* * *

(C) Corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

* * *

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

(4) Constructive ownership as actual ownership.—

(A) In general.—Except as provided in subparagraph (B), stock constructively owned by a person

*Section 318 was amended by P.L. 88-554 §5(a), effective August 31, 1964.

by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3) be treated as actually owned by such person.

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK. (After 1964 Amendment)

(a) GENERAL RULE. For purposes of those provisions of this subchapter to which the rules contained are expressly made applicable.—

* * *

(2) ATTRIBUTION FROM PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—

(A) FROM PARTNERSHIPS AND ESTATES.—Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.

* * *

(3) ATTRIBUTION TO PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—

(A) TO PARTNERSHIPS AND ESTATES.—Stock owned, directly or indirectly, by or for a partner or a beneficiary or an estate shall be considered as owned by the partnership or estate.

* * *

(C) TO CORPORATIONS.—If 50 percent or more in value of the stock in a corporation is owned, dirctly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

* * *

(5) OPERATING RULES.—

(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (4), shall for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person.

* * *

(C) PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owner by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

* * *

SEC. 334 BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

* * *

(b) LIQUIDATIONS OF SUBISDIARY.—

(1) IN GENERAL.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) EXCEPTION.—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—

(A) the distribution is pursuant to a plan of liquidation adopted—

(i) on or after June 22, 1954, and

(ii) not more than 2 years after the date of transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase as defined in paragraph (3) during a 12-month period beginning with the earlier of,

(i) the date of the first acquisition by purchase of such stock, or

(ii) if any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made, then the basis of the property in the hands of the distributee shall be the adjusted basis of stock with respect to which the distribution was made. For

purposes of the preceding sentence, under regulations prescribed by the Secretary or his delegate, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to a distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) PURCHASE DEFINED.—For purposes of paragraph (2)(b), the term "purchase" means any acquisition of stock, but only if—

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in hands of the person fom whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),

(B) The stock is not acquired from a person the which section 351 applies, and

(C) the stock is not acquired from a person the ownrship of whose stock would, under section 318(a), be attributed to the person acquiring such stock.

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For

purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

SEC. 708. CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE.—For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION.—

(1) GENERAL RULE.—For purposes of subsection (a), a partnership shall be considered as terminated only if—

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

APPENDIX D.

Excerpt From Senate Committee Report on P. L. 88-554, 2 U.S. Cong. & Adm. News '64, p. 3401, Amending Section 318.

"The operation of these two attribution rules together means for example, that stock of a corporation held by a partner is considered to be stock held by any partnership of which he is a member (agency rule). This stock which is considered to be held by the partnership, is then attributed (to the extent of his interest) to any other partner in the partnership (beneficial ownership rule). This double application of these rules has become known as sidewise attribution. . . .

"This double, or sidewise, attribution has the effect of attributing one person's stockholding to another even though there is neither an economic nor a family connection between the two persons. The effect of this sidewise attribution often is that a redeeming shareholder has 100 percent of the stock attributed to him and in no event will he be able to meet the requirements of the statutory provisions making it clear that the redemption is not a dividend.

. . . .

"Your committee concluded, since there is no basis either in family relationship or in common economic interest for the application of these two attribution rules at the same time, that sidewise attribution should be eliminated from the constructive ownership rules of present law. This is in accord with numerous recom-

mendations of technical advisory groups which have concerned themselves with this problem.

"Your committee's amendment eliminates this sidewise attribution by providing that when stock is attributed to a partnership, estate, trust, or corporation from a partner, shareholder or beneficiary (agency rule), this stock is not again to be attributed to another partner, (beneficial ownership) rule. This is the only substantive change made in these rules."

APPENDIX E.

Excerpt From Petition for Rehearing to Court of Appeals, Filed August 22, 1969.

IV.

Appellant Is Entitled to a Stepped Up Basis, Irrespective of Section 334(b)(2), Under the Kimbell-Diamond Doctrine. This Court's Decision Is in Conflict With That Case and With a Recent Decision of the Court of Claims.

It is undisputed that appellant purchased the stock of Old Baker and Kerman Tallow in 1961, and Veronica in 1962, for the express purpose of acquiring the assets of those corporations. In each case, the price was based on the value of the assets and did not include good will. Immediately after purchasing the stock, the acquired corporations were liquidated and the purchase price for the stock was allocated to the assets received in liquidation. Thus, a classic case is presented for an application of the doctrine that substance controls form, so that the transactions are treated for tax purposes as straight purchase of assets giving appellant a basis for such assets equivalent to their cost. The separate steps of purchasing stock and liquidation are in reality a single transaction. This was precisely the result reached under analogous facts in the landmark case of *Kimbell-Diamond Milling Co. v. Commissioner,* 14 T.C. 74 (1950), affirmed per curiam, 187 F.2d 718 (5th Cir. 1951), cert. den. 342 U.S. 827.

Although the *Kimbell-Diamond* case was decided prior to the 1954 Internal Revenue Code, and in fact

provided the rationale for Congress' inclusion of Section 334(b)(2) in the 1954 Code, a recent decision of the Court of Claims holds that *Kimbell-Diamond* remains viable in post 1954 Code years. The case is *American Potash & Chemical Corporation v. United States,* 339 F.2d 194 (Ct.Cl. 1968), on reheearing 402 F.2d 1000 (1968). It held that Congress' adoption of Section 334-(b)(2) did not pre-empt the *Kimbell-Diamond* doctrine, and therefore, Section 334(b)(2) is not the exclusive mechanism for obtaining an exception to the carryover basis rules of Section 334(b)(1), which apply to the normal liquidation of a subsidiary corporation by a parent.

Accordingly, even though the taxpayer in *American Potash* admitted failure to comply with Section 334(b)-(2), the Court remanded the case for a further trial to determine the presence or absence of the factual circumstances wherein the *Kinbell-Diamond* doctrine has been, or should be, applied. In this regard, the Court said (at p. 209):

> "In general, it has been deemed applicable when an acquiring corporation planned from beginning to end (and had a subjective intent) to acquire assets of another corporation and, to obtain the assets, it either chose, or was required, to purchase the stock of the other corporation and liquidate. The stock purdhase is an interim, transitory step in what is deemed a single unified purchase of assets."

The instant case presents an even stronger case for application of the *Kimbell-Daimond* doctrine than does *American Potash*. Here, the liquidation followed the stock purchases immediately. In *American Potash,* there was an interval of seven months.

Also, the reason for non-compliance with the technical requirements of Section 334(b)(2) in *American Potash* was that the stock was not acquired within the required period of 12 months, but rather extended over some 14 months. Hence, neither the express letter nor the purpose of the statute's technical limitations were met. By contrast, in the instant case, the purpose of the statute was squarely met. It is only the Court's technical construction of Sections 318 and 334(b)(3)(C)—without any relevance to the purpose for such limitations—which prevents literal compliance with Section 334(b)(2).

We believe the Tax Court's findings and the undisputed facts of this case conclusively establish that the requirements for an application of the *Kimbell-Diamond* doctrine are present. At the very least, however, the Court should remand the case to the Tax Court for a further determination of the necessary factual issues, as the Court of Claims did in *American Potash.*

We recognize that this argument is being raised for the first time in this proceeding. However, we did not have the benefit of the *American Potash* case when the matter was decided by the Tax Court; and the report of the Court of Claims' decision had only reached the ad-

vance sheet stage by the time our appellate briefs were filed and we were unaware of it. In any event, it is certainly not too late to raise the point. One of the purposes of the Rehearing procedure is to permit parties to call to the Court's attention recent developments in the law which were not considered in the briefs or in the Court's opinion, and which have a material bearing on the proper disposition of the matter. Unquestionably, under these circumstances, substantial justice requires that this question be considered by the Court. To refuse, would merely add one more technical justification for an unconscionable tax result which may well cause the financial ruin of this appellant.

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1036

BAKER COMMODITIES, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1–16) is reported at 415 F. 2d 519. The opinion of the Tax Court (Pet. App. 17–81) is reported at 48 T.C. 374.

JURISDICTION

The judgment of the court of appeals was entered on August 8, 1969 (Pet. App. 1). Petitioner's petition for rehearing was denied on October 7, 1969 (415 F. 2d 519). The petition for a writ of certiorari was filed on January 5, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

The ultimate issue here presented is whether the court of appeals erred in holding that petitioner's bases in assets acquired on liquidation of wholly-owned subsidiary corporations, effected immediately after acquisition of each subsidiary's stock, were the same as the bases which those assets had in the hands of the liquidated corporations, rather than petitioner's higher cost of its stock in the liquidated corporations. Resolution of that issue presents the following questions:

1. Whether the judicially promulgated *Kimbell-Diamond* doctrine [1] survived the enactment of Section 334(b)(2) of the Internal Revenue Code of 1954.

2. Whether, in the circumstances of this case, the courts below properly applied the statutory rules of stock attribution prescribed in Section 318 of the Code prior to its amendment in 1964.

3. Whether the courts below correctly determined that the Manchester Medical Hospital partnership continued to exist after the sale of its operating assets, because the partnership had not been dissolved or terminated and was still collecting and distributing the proceeds of the installment note it received in the sale.

STATUTES INVOLVED

The pertinent provisions of Sections 318, 334 and 708 of the Internal Revenue Code of 1954 are set forth in the Appendix to the petition (pp. 82–87). Section 7701(a)(2) of the Code is set forth in the Appendix, *infra*, p. 15.

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[1] *Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 719 (C.A. 5), certiorari denied, 342 U.S. 827.

STATEMENT

The present controversy concerns the proper bases to be assigned to assets acquired by petitioner, a California corporation, on liquidation of three wholly-owned subsidiary corporations. The stock of two of the subsidiaries, Baker Commodities, Inc. (herein called "Old Baker" to distinguish it from petitioner which bears the same name) and Kerman Tallow Works ("Kerman"), was acquired by petitioner on June 26, 1961, and these subsidiaries were liquidated on June 30, 1961. The stock of the third subsidiary, Veronica Compania Naviera, S.A. ("Veronica") was acquired on December 20, 1962, and that subsidiary was liquidated not later than December 31, 1962. (Pet. App. 5–6, 29, 37–38, 49–51.)

The following facts are relevant to the application of the "attribution" rules of Section 318 of the Internal Revenue Code:

1. Petitioner acquired all of Old Baker's stock and 50 percent of Kerman's stock from the Jerome Brothers partnership (the "Partnership"), whose partners were Frank, Varney and Paul Jerome (the "Jeromes"), and the balance of Kerman's stock from the R. S. Wilson Company, which was owned by Robert S. Wilson. It acquired all of Veronica's stock from the Jeromes. As of June 26, 1961, and at all relevant times thereafter, the Jeromes, six key employees of the Partnership and Jack Keith each owned 10 percent of petitioner's outstanding stock. (Pet. App. 3–6, 21–23, 28–29, 49–50.)

Apart from the Partnership, the Jeromes were members of a general partnership called Keith Engi-

neering Company ("Keith"). Jack Keith was a 50 percent partner, and the other 50 percent was equally divided among the Jeromes. The Jeromes also were general partners in a limited partnership, Manchester Medical Hospital ("Manchester"), in which each owned a one-ninth interest. Five of the six key employees of the Partnership who were stockholders of petitioner also were limited partners in Manchester. (Pet. App. 6–7, 23–24, 43–45.)

2. Manchester was organized on or about January 1, 1958, for the purpose of constructing, owning and operating a convalescent hospital. A convalescent hospital was in fact built and operated by Manchester; however, it ran into severe financial difficulties and was shut down in July, 1960. On March 1, 1961, the partnership sold all of its assets to Southwest Community Hospital Association, a nonprofit corporation, which was unrelated to any of Manchester's partners or to any of the parties or entities involved in this case. Southwest gave a promissory note for the purchase price which was secured by a chattel mortgage and deed of trust on the hospital property. Information returns were filed by Manchester for its fiscal years 1961 and 1962. The 1961 return reported the sale of assets; the 1962 return, for the fiscal year ended August 31, 1962, reported collections on the installment sale of $36,623.97. No other receipts or income was reported on the 1962 return; however, the note from Southwest was shown as an asset with an amount due of $12,500. No proof of any final liquidation and distribution of the assets of this partnership was offered at trial. (Pet. App. 6–7, 43–45.)

3. Following the liquidations of Old Baker, Kerman and Veronica, petitioner apportioned the cost of the stock of each corporation to the assets distributed by that corporation in liquidation (Pet. App. 5–6). On audit of petitioner's income tax returns for the fiscal years ended June 30, 1962 and June 30, 1963, the Commissioner disallowed the new bases for the assets, which petitioner had taken in reliance on Section 334(b)(2) of the Internal Revenue Code. He determined that those assets had the same bases in petitioner's hands—which bases were lower than the cost of the stock—that they had had in the hands of the liquidated corporations. The Commissioner's determination was predicated on the ground that petitioner did not acquire the stock in the liquidated corporations by "purchase" as required by Section 334(b)(2) and defined in Section 334(b)(3), because (a) its shares in Old Baker and Kerman were acquired in exchanges to which Section 351 applied and (b) it acquired the stock of all three corporations from a person or persons—the Partnership or the Jeromes—whose ownership of the stock was attributable to petitioner under the rules of constructive stock ownership prescribed in Section 318(a). The Tax Court sustained the Commissioner's determination on both grounds (Pet. App. 64–75, 77–81). The court of appeals did not pass on the Section 351 issue. It affirmed on the second ground, holding that there was no "purchase" because, immediately prior to each acquisition, petitioner was deemed to own, by reason of the statutory rules of stock attribution, the stock it thereafter acquired (Pet. App. 8–16).

The court reached this conclusion by the following process (Pet. App. 9–10):

First, 30 percent of petitioner's stock was attributed to the Partnership, since each of the Jeromes owned 10 percent of petitioner's stock, and stock actually owned by a partner is deemed to be owned by the partnership. Section 318(a)(2)(A).

Second, an additional five percent of petitioner's stock was attributed to the Partnership through Keith. Jack Keith owned 10 percent of petitioner's stock and also owned a 50 percent interest in Keith, the other 50 percent being owned by the Jeromes. Since stock owned by a partner is deemed to be owned by the partnership, Jack Keith's 10 percent interest in petitioner is deemed to be owned by Keith. Half of that 10 percent interest is in turn attributable to the Jeromes because stock constructively owned by a partnership is deemed to be owned proportionately by its partners. Finally, the stock so attributable to the Jeromes is re-attributable to the Partnership. Sections 318(a)(2)(A) and 318(a)(4).

Third, an additional 16⅔ percent of petitioner's stock was attributed to the Partnership through Manchester. Five of Manchester's limited partners owned a total of 50 percent of petitioner's stock, and the Jeromes had a total ⅓ interest in Manchester. Therefore, under the same rules as were applicable to Keith, the Jeromes were deemed to own ⅓ of Manchester's 50 percent interest in petitioner, which was ultimately attributed to the Partnership. Sections 318(a)(2)(A) and 318(a)(4).

Fourth, because the Partnership was deemed to own a total of more than 50 percent of petitioner's stock (51⅔ percent), petitioner was deemed to own the stock acquired by it from the Partnership and did not, therefore, acquire that stock by "purchase." Sections 318(a)(2)(C)(ii) and 334(b)(3)(C).

Finally, the court rejected (Pet. App. 11–16) petitioner's claim that there should be no attribution of petitioner's stock through Manchester because Manchester had ceased to exist prior to the time of the liquidations in 1961 and 1962. It held that although Manchester sold its operating assets in March, 1961, the partnership was not terminated at the time of the liquidations, since it retained assets and had not itself been dissolved or liquidated by the end of 1962.

ARGUMENT

The decision below, affirming that of the Tax Court, is correct. There is no conflict or any other ground for further review by this Court.

1. Petitioner relies most heavily (Pet. 11) on the argument that the court of appeals erred in failing to invoke the *Kimbell-Diamond* doctrine[2] and that its decision conflicts in principle with the rationale followed by the Court of Claims in *American Potash & Chemical Corp.* v. *United States*, 399 F. 2d 194, on rehearing, 402 F. 2d 1000.

The *Kimbell-Diamond* doctrine, which was developed judicially under the 1939 Code, permitted a tax-

[2] *Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 T.C. 74, affirmed *per curiam*, 187 F. 2d 718 (C.A. 5), certiorari denied, 342 U.S. 827.

payer that purchased the stock of a corporation for the sole purpose of liquidating it and acquiring the liquidated corporation's assets, to use, as the basis for the assets, the taxpayer's cost of the stock rather than the basis of the assets in the hands of the liquidated corporation. In enacting the 1954 Code, Congress incorporated the *Kimbell-Diamond* doctrine in Section 334(b)(2), which, on certain express conditions, provides an exception to the general rule of Section 334(b)(1), that property received by a corporation on liquidation of a subsidiary retains, in the hands of the transferee, the same basis that it had in the hands of the liquidated corporation. In *American Potash, supra,* the Court of Claims held that failure to comply with one of the conditions prescribed in Section 334(b)(2)—in that case the requirement of Section 334(b)(2)(B) that the stock of the subsidiary be acquired within a 12-month period—does not preclude a corporate taxpayer from acquiring a stepped up basis on liquidation of a subsidiary, if the taxpayer meets the requirements of the *Kimbell-Diamond* doctrine.

We submit that there is no conflict with *American Potash.* Petitioner did not argue in the Tax Court that this case was to be decided under the *Kimbell-Diamond* doctrine rather than by reference to Section 334(b)(2). Petitioner raised this issue for the first time in its petition for rehearing in the court of appeals (Pet. App. 90–93), which was denied without comment. Since the court of appeals usually does not consider new theories on petition for rehearing

(*Stephens* v. *Arrow Lumber Co.*, 354 F. 2d 732, 734 (C.A. 9); *Mitchell* v. *Greenough*, 100 F. 2d 1006 (C.A. 9)), there is no basis for the assumption that it gave any consideration to the merits of the argument based on the *Kimbell-Diamond* rationale. In these circumstances, and in the absence of any expression of views by the court of appeals regarding *Kimbell-Diamond*, it cannot be said that a conflict of any kind exists between the decision below and *American Potash*, or that the matter is in a proper posture for review by this Court.[3]

The petition does not suggest any reason why it would have been improper for the court of appeals to decline to consider, as untimely made, the argument that *Kimbell-Diamond* applies in this case. Refusal to consider that newly advanced argument on rehearing was particularly appropriate here, since a holding that the *Kimbell-Diamond* doctrine is still viable would not finally dispose of the case. A new trial would be necessary because the Tax Court, under the issues framed by petitioner, had no occasion to, and did not, make any findings of fact regarding petitioner's intent in acquiring the liquidated corporations.

Moreover, it is clear that the *Kimbell-Diamond* doctrine was supplanted by Section 334(b)(2) in cases involving acquisitions of stock by corporate taxpayers. Application of that doctrine created confusion because

[3] As petitioner acknowledges (Pet. 14), *American Potash* was remanded for a determination as to whether *Kimbell-Diamond* was applicable in the circumstances of that case. There is thus no final 1954 Code decision permitting a corporate taxpayer like petitioner to step up its basis in the assets of a liquidated subsidiary where it has failed to comply with the conditions prescribed in Section 334(b)(2).

it required factual findings as to subjective intent. This led to uncertainty in an area where certainty is essential. House Hearings before the Committee on Ways and Means on General Revenue Revision, 83d Cong., 1st Sess., pp. 1319, 1329–1330; Cohen, Gelberg, Surrey, Tarleau and Warren, *Corporate Liquidations under the Internal Revenue Code of 1954*, 55 Colum. L. Rev. 37, 40–43 (1955). Section 334(b)(2), with its objective criteria, was designed to provide the required certainty. H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 38, A100, A109–A110; S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 48, 254, 257; H. Conf. Rep. No. 2543, 83d Cong., 2d Sess., p. 36. To hold that *Kimbell-Diamond* applies in the circumstances of this case thus would frustrate the principal purpose of Section 334(b)(2) and do violence to the manifest intent of the Congress which enacted that provision. See. S. Rep. No. 1622, *supra*, p. 257.

2. Petitioner concedes (Pet. 26, n. 14) that this is a case of first impression involving "multiple attribution" under Section 318. Petitioner also concedes (Pet. 26) that the result reached below "is no longer possible * * * because of the 1964 amendment to § 318."[4] This, without more, we submit, is a sufficient basis for this Court to deny further review of the Section 318 issue. But apart from the fact that the decision below is unique, there can be no doubt that both courts below correctly held that Section 318

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[4] Section 318(a)(5)(C), added by the Act of August 31, 1964, P.L. 88–554, 78 Stat. 761, Sec. 4, provides that stock is not to be attributed from partner to partnership and then to other partners. Had that provision been applicable here, the Partnership would not have been deemed to own any of the stock attributed to it through Keith and Manchester.

(prior to its amendment in 1964) required multiple reattribution of the stock of Old Baker, Kerman and Veronica. The pertinent statutory language is unequivocal, as petitioner acknowledged in the Tax Court (Pet. App. 80, n. 30), and petitioner cites no authority for its assertion (Pet. 24) that Congress did not mean precisely what it said.[5]

3. Similarly without merit is petitioner's contention that the courts below erred in holding that Manchester was a viable partnership for purposes of attribution under Section 318. The fact is that even at the time of the Veronica liquidation in December 1962, Manchester was in existence—none of its partners had withdrawn, its affairs had not yet been wound up and it had not been dissolved under applicable California law (Pet. App. 6–7, 11–16, 43–45). Manchester was, therefore, a partnership at all critical times within the meaning of Section 7701(a)(2), which defines a partnership to include "a syndicate, group, pool, joint venture, or any other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on."

Petitioner's argument that Manchester's existence or non-existence should be determined by reference

[5] Petitioner professes bafflement (Pet. 25) regarding the reattribution of the Veronica stock, since it acquired that stock from the Jeromes, while the stock of Old Baker and Kerman was acquired from the Partnership. It is sufficient to note that throughout these proceedings the Jeromes and the Partnership have been treated interchangeably (Pet. App. 5–6, 9–10, 77–81), and that at no time—even on rehearing—did petitioner question this treatment.

to Section 708(b), which relates to a termination of a partnership, rather than under Section 7701, is incorrect. Section 7701(a) provides that the definitions therein contained are to be applied "where not otherwise distinctly expressed or manifestly incompatible with the intent" of any operative provision of the Code. The rules of Section 708, on the other hand, are to be applied only "[f]or purposes of this subchapter" (Subchapter K relating to partnerships). See Section 708(a). Since Section 318 is not a part of Subchapter K, Section 708(b) is not applicable in determining whether Manchester had been terminated for purposes of the Section 318 attribution rules. Furthermore, as the court of appeals held (Pet. App. 13–16), even if Section 708(b) were applicable, Manchester had not been terminated within the meaning of that provision.

Finally, petitioner's assertion (Pet. 17) of a conflict with *Barran* v. *Commissioner*, 334 F. 2d 58 (C.A. 5); *Hatch's Estate* v. *Commissioner*, 198 F. 2d 26 (C.A. 9); and *Thornley* v. *Commissioner*, 147 F. 2d 416 (C.A. 3), is undercut by its admission (Pet. 20) that the question of what constitutes a termination of a partnership under Section 318 is one of first appellate impression. The cited cases deal only with the question of termination in connection with the partnership provisions of the Code, and, in any event, turn upon factual findings that the partners intended to terminate the partnerships there involved. No similar findings were made here.[6]

[6] *Hatch's Estate* v. *Commissioner*, *supra*, was decided by a three-judge panel of the Ninth Circuit and, of course, is not in conflict with the decision of the Ninth Circuit below.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 1970.

APPENDIX

Internal Revenue Code of 1954:

SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

[26 U.S.C. 7701.]

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IN THE

Supreme Court of the United States

October Term, 1969
No. 1036

BAKER COMMODITIES, INC.,

Petitioner,

vs.

THE UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

PETITIONER'S REPLY BRIEF.

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PETITIONER'S REPLY BRIEF.

Preliminary Statement.

Petitioner, Baker Commodities, Inc., offers this reply to the Brief for the Respondent in Opposition to petitioner's petition for a writ of certiorari.

ARGUMENT.

I.

Contrary to Respondent's Position, the Question Concerning the Viability of the Kimbell-Diamond Doctrine Presents Appropriate Grounds for Review by This Court.

A. The Petition Presents a Conflict in Reasoning and Result Between the Instant Case and a Recent Decision of the Court of Claims.

In opposition to the petition herein, respondent first attacks petitioner's contention that the reasoning and result of the decisions below conflict with the reasoning and result of the Court of Claims in the case of *American Potash & Chemical Corp. v. United States*, 399 F. 2d 194 (Ct. Cl. 1968), on rehearing 402 F. 2d 1000 (1968).

As we pointed out in the petition, the Court of Claims decided in that case that the stepped-up basis provisions of section 334(b)(2) of the Internal Revenue Code of 1954 did not pre-empt the *Kimbell-Diamond* doctrine.[1] Accordingly, failure to meet the technical requirements of that section was held not to be an automatic bar to a stepped-up basis (measured by cost) when a corporate taxpayer acquires the assets of another corporation by purchasing its stock and then liquidating it. Such reasoning and result are squarely in conflict with the instant case.

Although respondent asserts that there is no conflict with *American Potash*, a careful reading of respondent's

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[1] *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), aff'd. per curiam 187 F. 2d 718 (5th Cir., 1951), cert. denied 342 U.S. 827, 72 S. Ct. 50, 96 L. Ed. 626.

brief will show that the Government does not really deny that the rationale of the Court of Claims produced a result which is totally inconsistent with the instant case. Rather, the thrust of the Government's argument is that petitioner's reliance on *American Potash* was untimely because it was raised for the first time on petition for rehearing and, therefore, was properly ignored by the Ninth Circuit Court of Appeals. (Br. Resp. Opp. pp. 8-9.)

If, by this, respondent means that there is no conflict because the Ninth Circuit refused to recognize the existence of a contrary authority, so that the opinion below does not disclose the conflict on its face, we submit that respondent is proposing an undue restriction on the type of controversy which warrants review by this Court. Notwithstanding the failure of the Ninth Circuit to comment on the *American Potash* rationale or state any reason for denying the petition for rehearing, it is indisputable that the two decisions cannot be reconciled in principle; both cannot represent correct interpretations of the law. Beyond question, if the instant case were presented to the Court of Claims, petitioner would not have been denied a stepped-up basis under the undisputed facts found by the Tax Court. The alleged noncompliance with section 334(b)(2) would have meant only that petitioner would have received its cost basis by virtue of the principle that the substance of each transaction was a direct purchase of assets (disregarding the intermediate step involving liquidation of the subsidiary), instead of by virtue of the Code provisions dealing with the liquidation of subsidiaries. (See Pet. pp. 11-17.)

B. The Viability of Kimbell-Diamond Presents an Important Question of Federal Law Which Has Not Been but Should Be Settled by This Court.

Even if it could be said that there is no "conflict" within the contemplation of paragraph (a) of Rule 19 of this Court's rules, because the opnion below does not mention the *American Potash* case or its rationale, we submit that the important question raised herein as to the viability of the *Kimbell-Diamond* doctrine justifies a review by this Court under paragraph (b) of Rule 19.

Respondent's brief makes it clear that the Commissioner of Internal Revenue does not agree with the holding in *American Potash* and will argue in future cases that "the *Kimbell-Diamond* doctrine was supplanted by section 334(b)(2) in cases involving acquisitions by corporate taxpayers." (Br. Resp. Opp. pp. 9-10.) As we pointed out in the petition, the *Kimbell-Diamond* type transaction is one of the most commonly used methods whereby one corporation acquires the assets of another corporation. The question of whether or not the *Kimbell-Diamond* doctrine can be applied independently of section 334(b)(2) will certainly have to be faced again. In the meantime, respondent's opposition to *American Potash* will lead to confusion in business planning and the administration of the revenue laws, producing extensive and expensive litigation. The instant case represents a ready opportunity for this Court to review and decide the question now, thereby avoiding those problems.[2]

---

[2]Obviously, respondent would prefer to wait for some other case as the vehicle to raise this question. To agree to certiorari in the instant case, would mean acceptance of an obviously unfavor-

Finally, if it is indeed the law that *Kimbell-Diamond* is still viable, the doctrine should be upheld by this Court *in this very case to prevent a manifest injustice to this taxpayer which can be avoided only if the court grants certiorari.* Petitioner has already suffered unfairly from the fact that Congress did not amend section 318 until after the tax years in question. Under the law as amended, the absurd application of the attribution rules which produced the so-called technical failure to comply with section 334(b)(2) relied upon by the Ninth Circuit, is expressly precluded. In other words, petitioner did comply with the technical requirements of section 334(b)(2) as they now exist—and, we submit, as Congress obviously intended them to be from the very beginning.[3] If certiorari is now refused, but the *American Potash* rationale is ultimately upheld in another case, so that even a true technical non-compliance should not have prevented the stepped-up basis, it will compound the incredible miscarriage of justice perpetrated upon this petitioner.

C. Petitioner's Reliance on American Potash Was Timely.

With respect to the question of timeliness, we submit that respondent's argument is simply an attempt to avoid facing this important issue, which goes to the

able fact situation from the Government's standpoint, in that the alleged technical non-compliance with section 334(b)(2) had no substantive effect on the transaction. It is difficult to conceive of a clearer situation wherein the subjective intent necessary for *Kimbell-Diamond* to apply could be present. Moreover, respondent is understandably reluctant to risk the loss of the large deficiency which it has already won in this case.

[3]See the reasons stated for elimination of multiple reattribution in 2 U.S. Code Cong. & Adm. News '64, p. 3401, Senate Committee Report on P. L. 88-554. (Reprinted in part in Appendix D, Pet. App. pp. 88-89.)

very heart of the controversy over whether or not petitioner was entitled to the stepped-up basis. Indeed, throughout this case, respondent has repeatedly relied on technical arguments without offering any reasons why the result sought was just or in accordance with the real objectives of the revenue laws involved.

Furthermore, petitioner denies that its reliance on *American Potash* was untimely. That case was not decided until July 17, 1968, more than a year after the Tax Court decision in the instant case. As we pointed out in the petition for rehearing to the Court of Appeals:

> "We recognize that this argument is being raised for the first time in this proceeding. However, we did not have the benefit of the *American Potash* case when the matter was decided by the Tax Court; and the report of the Court of Claims' decision had only reached the advance sheet stage by the time our appellate briefs were filed and we were unaware of it. In any event, it is certainly not too late to raise the point. One of the purposes of the Rehearing procedure is to permit parties to call to the Court's attention recent developments in the law which were not considered in the briefs or in the Court's opinion, and which have a material bearing on the proper disposition of the matter. Unquestionably, under these circumstances, substantial justice requires that this question can be considered by the Court. To refuse would merely add one more technical justification for an unconscionable tax result which may well cause the financial ruin of this appellant." (Pet. App. E, pp. 92-93.)

It is submitted that in principle, this situation is analogous to one where an authority relied upon by a court in reaching its decision has been reversed and the reversal is called to the court's attention by a petition for rehearing. In such case, the decision relying on the reversed authority is erroneous and should be vacated on rehearing, or at least modified and placed on some other legitimate ground. See, *Brenna, et al. v. Federal Cartridge Corporation,* 183 F. 2d 414 (8th Cir. 1950). As we stated above, this is one of the purposes for the rehearing procedure. So long as the petition for rehearing is itself timely (as it was here), the court's decision is not yet final. If it is wrong, it should be corrected.

The authorities relied upon by respondent to justify the Ninth Circuit's refusal to consider *American Potash* on rehearing are plainly distinguishable and inapplicable. In *Stephens v. Arrow Lumber Co.,* 354 F. 2d 732 (9th Cir. 1966), an appellant attempted to raise for the first time on appeal a new and inconsistent claim which could have been presented to the trial court. Similarly, in *Mitchell v. Greenough,* 100 F. 2d 1006 (9th Cir. 1939), the losing party on appeal attempted on petition for rehearing to rely on a three-year statute of limitations rather than the two-year statute which had been held applicable by the court. The critical difference in both of these cases is that the party attempting to raise the new and different issue was not relying on any new cases or developments in the law having an undeniable and material impact on the issues before the court, as is true here. Indeed, in the *Mitchell* case the court expressly pointed out as an alternative ground for denying the petition for rehearing that the different statute

of limitations urged by the petitioner (which had been in existence all the time) would not have changed the court's ultimate decision on the merits.

In the instant case, petitioner did not attempt to "shift" to an inconsistent or totally new and different position which would require the court to reconsider the case *in toto*. The essential issue in the case was whether the Commissioner of Internal Revenue improperly denied petitioner a stepped-up basis. However, everyone, including the parties and the courts, were under the impression that a stepped-up basis in a *Kimbell-Diamond* transaction could only be allowed through technical compliance with section 334(b)(2). The Tax Court, in fact, expressly discussed the *Kimbell-Diamond* doctrine and suggested that the technical requirements in section 334(b)(2), as the statutory embodiment of that doctrine, were "an attempt to limit the availability of the stepped-up basis." (Pet. App. B, pp. 65-66.) Of course, petitioner contended, and still contends, that those technical requirements were complied with. The point is, petitioner was not changing its position or raising a totally unrelated new issue when it discovered the *American Potash* decision and urged it to the Ninth Circuit. Petitioner was simply pointing out that under a newly discovered recent interpretation of the law the Tax Court's belief that technical compliance with section 334(b)(2) was the exclusive method of obtaining a stepped-up basis was no longer correct and should not have been affirmed.

Respondent argues that a holding that the *Kimbell-Diamond* doctrine is still viable would not finally dispose of the case and that a new trial would be necessary. Such contention has no merit for two reasons: First, the court's proper function is not to dispose of cases as

quickly as they can be decided, regardless of whether justice is served. Where the court has decided a case on erroneous grounds, it should not be permitted to stand on that decision for the sake of mere expedience. If justice requires a rehearing, or even a remand to the trial court for further proceedings, it is the court's duty to take such action.

Secondly, a complete new trial certainly would not be necessary here. Indeed, we submit that no further evidence at all is needed and the most that could be required of the Tax Court would be to make a finding as to whether or not petitioner purchased the stock of the three corporations in question for the purpose of acquiring their assets. Actually, we believe the findings already made by the Tax Court conclusively establish such intent by necessary implication. In any event, the indisputable facts that the price was based primarily on appraisals of the assets, and the corporations were liquidated immediately, provide ample basis for the appellate court to assume that the necessary intent would have been found by the Tax Court on remand.[4]

---

[4]This situation should be contrasted with *American Potash* where the facts did not indicate so clearly the existence of the subjective intent to acquire assets. (The subsidiary corporation was operated for a period of seven months before liquidation.) For that reason, the case had to be remanded for further proceedings.

We wish to point out also that respondent missed the point in arguing that because of the remand in *American Potash*, there is "no final 1954 decision permitting a corporate taxpayer like petitioner to step up its basis in the assets of a liquidated subsidiary where it has failed to comply with the conditions prescribed in section 334(b)(2)." The real significance of the *American Potash* case does not depend on whether or not the taxpayer ultimately prevails on the facts. The point is that it does represent an appellate level final decision that the *Kimbell-Diamond* doctrine is viable and can be applied independently of section 334(b)(2).

II.

The Petition Presents Important Questions Concerning Mutliple Stock Attribution and the Interrelationship of Sections 318 and 334(b)(2), Which Were Not Disposed of by the 1964 Amendment to Section 318.

Respondent suggests that no proper question for review by this Court is raised with respect to multiple stock attribution because petitioner concedes that this is a case of first impression on that subject, and because "the result reached below" is no longer possible in view of the 1964 amendment to section 318. In so arguing, respondent has grossly over-simplified the questions which the petition presents.

To begin with, it is certainly no bar to certiorari that the matter raised is one of first impression. Under Rule 19(b) of the rules of this Court, important questions of federal law may be settled by this Court even though there is no conflict in the decisions of the lower courts.

As for the 1964 amendment to section 318, it is true that the extreme and extraordinary result reached below is no longer possible (leaving petitioner as the only known taxpayer to suffer from Congress' original mistake). But the amendment only eliminated multiple reattribution of the same stock, from a partner to his partnership and out to another partner (in this case it was even reattributed to a second separate partnership in which the actual owner of the stock had absolutely no interest). The amendment in no way affects the result of this case insofar as it holds that a purchase intended to comply with section 334(b)(2) can be dis-

qualified as a non-arm's length acquisition under section 334(b)(3)(C), solely by virtue of *constructive* ownership—worse yet, constructive ownership created by combining stock attributed from *diverse and unrelated sources.* (We respectfully refer the Court again to the discussion of these points in the petition, at pp. 23-26.)

It is our contention that the clear intent of Congress in adopting section 334(b)(3)(C), with its reference to section 318, was to deny the important benefits of section 334(b)(2) to corporations which buy the stock of another corporation from their own controlling stockholder. In order to be a "person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock," as used in section 334(b)(3)(C), the seller must own 50% or more of the acquiring corporation, thereby activating the rule of shareholder-corporate attribution. But did Congress also intend that such fatal 50% ownership of the acquiring corporation could itself be created constructively in the seller by applying other attribution rules, such as partnership attribution from a partnership having no business connection with the acquiring or acquired corporations? We strongly urged that the artificial control thus created for the seller—particularly where actual control is shown not to exist—cannot be justified as a basis for applying section 334(b)(3)(C), in light of the objectives of the statute. Yet, that result is still possible, and indeed is *required*, under the construction of the statutes adopted by the courts below.

Respondent does not offer any reasons why such result is either just or consistent with Congressional objectives. We submit there are none. It is no answer to this argument to simply say, as respondent does, that

Congress meant what it said, or to counter that petitioner "cites no authority for its assertion." (Br. Resp. Opp. p. 11.) Surely, the courts can determine Congressional intent and the underlying objective of the statutes in question by applying logic and common sense. They should be construed in accordance with that intent and objective.

The final point we wish to make on this question is that respondent is totally in error when it states, in footnote 5 of its brief, on page 11, that throughout these proceedings the Jeromes as individuals and the Jerome Brothers Partnership have been treated as interchangeable, and that at no time did petitioner question such treatment. Respondent offers this statement in answer to the point raised in the petition that the courts below failed to distinguish the 1962 Veronica stock purchase, which was from the three brothers as individuals, from the 1961 transaction wherein the stock was purchased from the Jerome Brothers Partnership. The significance of this is that in no event should the Veronica transaction have resulted in the loss of a stepped-up basis, because ownership interests of separate sellers—even brothers—cannot be combined for purposes of applying sections 318 and 334(b)(3)(C).

Contrary to respondent's contention that this point was never made below, we quote the following paragraph from our opening Brief for Appellant to the Court of Appeals (at p. 53, n. 15):

> "With respect to the 1962 transaction, another fiction was also employed. The Veronica stock was acquired from the Jeromes as *individuals* and could not be attributed to appellant except in a roundabout fashion through attribution to the Jerome

> Brothers partnership. This is because no individual Jerome had as much as 50% of appellant's stock and their separate ownership could not be combined for Section 318 purposes. *Stevens Pass, Inc., supra,* at 539, n. 5 (dictum)."[5]

At all times, in stating the facts to both lower courts, petitioner was careful to point out this difference in ownership between the 1961 and 1962 transactions. (See, also, p. 13 and p. 14, n. 4 of petitioner's opening brief to the Court of Appeals.) The Tax Court itself, in its findings of fact, correctly stated that the stock was owned by and acquired from the Jerome brothers as individuals. (Pet. App. B. pp. 47-50.) The Court of Appeals also observed the distinction in stating the facts. (Pet. App. A. p. 6.) Never, at any time, did either of the lower courts ever state directly or indirectly that the three Jeromes and their partnership were interchangeable for tax purposes, or that their separateness should be disregarded in any way. The courts simply failed to consider the significance of such separate status when they reached their legal conclusions.

III.

The Question of Partnership Termination for Purposes of Applying the Stock Attribution Rules Raises Appropriate Grounds for Certiorari.

Petitioner contends that the holding of the lower courts concerning the viability of Manchester partnership raised two appropriate grounds for review by this Court. First, there is the important question not yet decided by this Court as to when a partnership

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[5]48 T.C. 532 (1967).

ceases to exist as such for tax purposes, and particularly for section 318 purposes. Secondly, the decision of the Court of Appeals is in conflict with other appellate decisions cited in the Petition.

Respondent argues that the lower courts were correct in holding that Manchester remained in existence past December of 1962, since "none of its partners had withdrawn, its affairs had not yet been wound up and it had not been dissolved under applicable California law." (Br. Resp. Opp. p. 11.) Respondent is merely compounding the errors made by the lower courts with respect to California law. The March 1, 1961 sale of Manchester's entire business asserts and cessation of business definitely was a dissolution under California law for the unanswered reasons which are stated in the petition. Furthermore, the Court of Appeals did not really dispute that there was a dissolution; the disagreement with petitioner's position involved the effect of a dissolution on the agency relationship between partners and partnership, and the relevance of such relationship to stock attribution through a partnership under section 318. (See, Pet. pp. 20-23.)

Respondent contends that Manchester's existence or non-existence should be determined by reference to section 7701(a) of the Internal Revenue Code, rather than section 708. Section 7701 merely provides the definition of a partnership and offers little help as to when a partnership *terminates*. For that reason, we looked to section 708 for guidance, and we submit that respond-

ent has totally failed to meet our arguments. (See Pet. pp. 17-20.) But even the language of section 7701(a) supports petitioner's position, since the definition of a partnership plainly requires that a business be carried on. Here, all business activity ceased after the sale of Manchester's assets. The only activity of any kind was the collection of the sale price of the assets, which surely does not fall within the language of section 7701. (Pet. App. B. pp. 43-45.)

Respondent attempts to brush aside the conflict in principle between the instant case and three other appellate decisions (including two from other circuits) on the apparent ground that they did not specifically involve a partnership termination for section 318 purposes. The conflict in rationale is no less significant because section 318 was not involved in those cases. If a partnership terminates for other tax purposes on the sale of all its assets, as in those cases, on what basis can it be said to remain in existence for section 318 purposes?

In closing, we wish to point out again that neither the lower courts nor respondent have ever offered a single reason why the objectives of section 318 justify an interpretation which makes a partnership remain viable for stock attribution purposes in a subsequent unrelated transaction after it has sold all of its assets and ceased all business, has dissolved under state law terminating the agency relationship between partners as

to new matters, and has no existence for any purpose except to "wind up its affairs" by collecting the sale price.

Conclusion.

For the reasons stated herein and in the petition, it is submitted that a writ of certiorari should be granted.

Respectfully submitted,

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